US-China “strategic economic dialogue” underscores sharpening trade tensions

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An unprecedented US delegation sent to Beijing for the first session of a proposed twice-yearly “strategic economic dialogue” on December 14-15 highlights the sharpening trade tensions between the US and China.

Headed by US Treasury Secretary Henry Paulson, the high-powered team included virtually every senior US economic official: Federal Reserve Board chairman Ben Bernanke, US trade representative Susan Schwab and the secretaries of commerce, labour, energy, health and human services as well as the head of Environmental Protection Agency. A day before the US party arrived, former US President George Bush senior met Chinese President Hu Jintao.

As widely expected, nothing concrete came out of the “dialogue”. For all of the rhetoric calling for Chinese leaders to speed up “market reform,” the Bush administration was walking a fine line. While responding to protectionist demands from Congress, the White House is deeply concerned about the economic impact on the US and world economy of trade sanctions against China.

At the heart of the current crisis is China’s reluctance to allow a rapid revaluation of its currency, the yuan. Since ending the previous fixed exchange rate regime in July 2005, the yuan has revalued only 5.7 percent—far less than Congressional demands for a rise against the US dollar of 15-40 percent.

Sections of Congress, with the Democrats in the forefront, accuse China of “manipulating” its currency to damage the US economy. As many as 27 proposed bills threaten tariffs against Chinese exports to the US. As economists had predicted, the US trade deficit with China will reach a record $240 billion this year, up from $202 billion in 2005.

Paulson’s proposal in September for a US-China dialogue sought to extract concessions from Beijing and preempt drastic action in the Congress, particularly in the lead up to mid-term Congressional elections in November. Once the Democrats regained a Congressional majority, a more antagonistic approach dominated Washington’s debate on China.

New Democratic majority leader Nancy Pelosi strongly opposed China’s admission into the World Trade Organisation (WTO) in 2001. Commenting prior to the US-China dialogue, she declared: “Many of us in the Congress will be watching closely.”

Christopher Dodd, the incoming chairman of the Senate Banking Committee, demanded strong action. “I’ve listened to previous secretaries [of the treasury] talk about jawboning on this issue and being patient, ‘things are moving in the right direction’. But it’s pretty difficult to explain to the American people day after day that a major competitor of ours, now a member of the WTO, is still fixing its own rates at a great disadvantage to us.”

Just days before the US-China talks, a report by the US trade representative to Congress on China’s entry into the WTO accused Beijing of failing to meet WTO requirements, including opening up sections of the Chinese economy and cracking down on widespread copyright breaches.

If the bilateral dialogue failed, the report threatened, “the administration will not hesitate to employ the full range of enforcement tools available as a result of China’s accession to the WTO, whether it be the dispute settlement procedures at the WTO or the strict enforcement of US trade laws to ensure that US interests are not harmed by unfair trade practices”.

Paulson made no secret of Washington’s protectionist threats, saying: “I think the message in this report is consistent with our messages previously.” He told reporters the world would “run out of patience” if Beijing’s economic reforms, including a rapid revaluation of the yuan, moved too slowly.

When meeting with Chinese officials, however, Paulson significantly toned down his rhetoric. “As you know, there is resistance in both our countries to greater integration into the global economy, and there is also skepticism that this dialogue will accomplish anything of substance,” he declared.

More dramatic was Bernanke’s speech to the Chinese Academy of Social Sciences. The Federal Reserve chairman omitted an accusation that Beijing’s currency policy was an “effective subsidy” on exports, and grounds for charging China with violating WTO principles. Instead he used a less inflammatory term, describing the yuan regime as a “distortion” to global trade. Bernanke’s spokeswoman insisted he had not been under any pressure to modify his speech, even though the original version, with the term “effective subsidy,” was posted on the Fed’s website.

The Chinese government rejected US criticisms. Vice Premier Wu Yi warned: “Some American friends not only have limited knowledge of, but harbour misunderstandings about, the reality of China.” She pointed out that after the “extremely barbaric economic depredation” of the imperialist powers in nineteenth and early twentieth centuries, China was still a developing country with a per capita income of just $1,700. Wu reiterated Beijing’s policy of pro-market “reform and opening up” and promised greater protection of intellectual property rights and the “rule of law”.

The Bush administration is not interested in being lectured on the reality of China, however. With rising trade and budget deficits, the White House wants immediate action to make China’s currency trading more flexible and further deregulation of the state-run financial sector. At the same time, it needs to ensure that Congress will not disrupt the huge inflows of Chinese funds and cheap goods that are vital for the US economy.

Criticisms by Democrats and American trade union bureaucrats of China’s “unfair trade practices” reflect the deteriorating conditions in less competitive sections of US industry. Unable to match rivals that have shifted or outsourced production to China and other low-wage countries, these layers have to massively cut wages and conditions to stave off collapse. Protectionist measures will do nothing to stop the assault on the living standards of American workers, but are designed to divert attention from the real root of the rising social inequality and poverty—the profit system—and blame workers in China who are often exploited by the same US corporations.

The most powerful sections of the US financial elite oppose trade sanctions against China. Former President Bush senior told an audience of Chinese university students: “My worry is that some of the leaders in the new Congress are anti-free trade; they are more for protectionism.” The concern of the large US corporations is that protectionist measures will undermine their ability to invest and reap huge profits in China.

In a recent comment, the *Wall Street Journal* defended China’s economic policies as being more open than those of Japan and India. “When China won the WTO’s seal of approval in late 2001, it was a signal to the world that Beijing wasn’t going to turn its back on capitalism. That sent a flood of foreign investment sweeping into China, surging from roughly $40 billion annually in the years before 2002 to more than $70 billion last year.”

According to the US Commerce Department, China overtook Mexico this year as the second biggest trading partner of the US after Canada. US-China trade has reached $328 billion—10 times the level in 1992. In addition, China’s central bank is helping to finance the huge US trade and current account deficits and has accumulated $700 billion in US government bonds and other dollar-denominated assets. China now has foreign currency reserves of $1 trillion—the largest in the world. As the US dollar has weakened, the inflow of Chinese and Asian capital has been crucial in keeping the debt-stricken US economy afloat.

A major fear in Washington is that US tariffs against China will destabilise financial relations. A Chinese People’s Bank report, released on December 7, pointed to the dangers of a loss of international confidence in the US dollar. “If external capital stops flowing into the United States, a significant drop in the US dollar may occur with consumption and investment shrinking, interest rising and financial markets experiencing turbulence—endangering global financial and economic stability,” the report warned.

The Chinese central bank is trying to diversify its foreign currency reserve portfolios into euros, gold and other currencies to reduce the risk of relying on the greenback. Beijing is trying to reduce its dollar assets without creating panic and a rush out of the US market that would trigger financial turmoil. However, all major investors are doing the same, which is only increasing volatility in the financial and money markets.

As on other occasions, US and Chinese officials in the Beijing dialogue pointed to the need for China to encourage consumption-led economic growth. A more expensive yuan is widely regarded as a way of increasing the buying power of Chinese consumers and thus increasing imports from the US. The diversification of China’s financial system beyond the present state-run banks, the argument goes, could transform China’s high rate of saving into domestic spending.

However, this perspective is riddled with contradictions. While a small layer of the urban middle class has propelled a growth in consumption, the vast majority of the Chinese population—the working class and rural poor—are struggling to make ends meet. The impact of a higher yuan on exports could cost millions of jobs, leading to a decrease in consumption by Chinese workers.

To encourage domestic spending, Beijing would also have to significantly increase real wages and expand the provision of healthcare, education and pensions. But such measures would further undermine China’s main economic advantage as a source of cheap labour—leading to further job losses.

China’s textile industry, which alone supports directly and indirectly 100 million people, is particularly vulnerable. It is already operating on tight profit margins of 3-5 percent. The government has forecast that 15 million urban job seekers will not find a job next year. Beijing fears that any rise in job losses would lead to an eruption of social and political unrest.

A *Financial Times* editorial on December 18 warned Beijing must nevertheless make changes. “Either it responds constructively to Mr. Paulson’s initiative with actions that strengthen both its own economy and his ability to restrain more bellicose political forces at home; or it runs the risk that those [US protectionist] forces will prevail, with incalculable consequences for both countries’ interests. Given the strength of anti-Chinese feeling in the US, not much time is left to make that choice.”