Amid global financial instability: China-EU trade tensions intensify

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The 10th Sino-European Union summit in Beijing last week revealed the tense atmosphere that exists between the world's major economic powers, amid growing international financial instability. Brussels is pressuring Beijing to revalue the yuan, as the eurozone economies struggle to cope with the falling US dollar, weakening European exports and a surging trade deficit with China.

Zhou Xiaochun, the head of China's central bank, held talks with EU finance ministers chairman Jean-Claude Juncker, EU monetary affairs commissioner Joaquín Almunia and European central bank president Jean-Claude Trichet. Their joint statement called for "comprehensive measures to enhance structural economic adjustments, avoid big swings in currency movements and make respective contributions to an orderly adjustment of global imbalances".

The statement was clearly a compromise. Concerned about its own financial stability, China refused to accept the EU's demand for the revaluation of yuan against the euro. The reference to the need to adjust "global imbalances" indirectly pointed the finger at the precipitous decline of the US dollar, against which the yuan is basically pegged. The dollar has lost over 12 percent against the euro this year and the yuan has lost 6.5 percent—squeezing European exports and increasing European imports of Chinese and US goods.

Sharp exchanges took place just before the summit between EU trade commissioner Peter Mandelson and China's top trade official Chinese Vice Premier Wu Yi. At a forum in Beijing, Wu criticised Western countries for "politicising" safety scandals involving Chinese products as a means of setting up trade barriers. She stated that 99 percent of Chinese exports were safe and urged Western governments to "take immediate and effective action" against "false, immoral, biased and intentionally disruptive" media reports about Chinese goods.

Mandelson responded by declaring that it was unacceptable for even 1 percent of goods to be unsafe, saying: "Countries and companies that cannot provide the reassurance that they are exporting safe goods will not just lose customers they'll even see their products barred from other markets." He then added insult to injury by linking the safety issue to the EU's demands for Beijing to address "the tidal wave of counterfeit goods" made in China. Wu angrily declared herself "very dissatisfied" with Mandelson's words.

The real issue is not "consumer safety" nor even counterfeit goods as such, but the EU's massive and rising trade deficit with China. Mandelson told the media: "During the six days that I spent in China, the trade deficit will grow by over 2 billion euro, or 15 million euro an hour—that is what I call unsustainable". The EU deficit with China is expected to rise nearly 30 percent to 170 billion euro ($US250 billion) in 2007—more than half the expected total bilateral trade of 300 billion euro.

China has become a major market and production platform for European companies. But the immediate issue is the high value of the euro. EU finance chairman Juncker warned: "The fact that the Chinese currency is depreciating against the euro and appreciating against the dollar is creating a lot of problems for the European economy. We could have as a result protectionism occurring in Europe."

Although it officially ended the yuan's peg to the dollar in 2005, China only allows its currency to fluctuate within a relatively narrow band in order to maintain the competitiveness of Chinese goods in the US—the largest consumer market in the world. China has accumulated $1.4 trillion in foreign currency reserves—the world's largest—as a result of export earnings and the Chinese central bank's buying of US government bonds and other dollar-based assets.

The Bush administration and the US Congress accused Beijing of "manipulating" its currency, when the US-China trade deficit reached $232 billion last year. In the face of Washington's pressure, Chinese exports to Europe have grown rapidly in recent years.

The falling US dollar poses a dilemma for China. Firstly, it means China's mountain of dollar-denominated assets is losing value against the yuan and other currencies. One solution would be to diversify into euro-denominated assets or gold. However, even talk of such a move by China, which would be followed by other Asian central banks, has created panic in US financial markets. Given its dependence on exports to the US, Beijing cannot risk the US falling into recession, let alone a financial crisis.

A Chinese commerce ministry report published on November 14 warned that the subprime mortgage crisis and the resultant credit squeeze in the US will be "the biggest challenge" to the Chinese economy in the coming year. China's central bank has estimated that every 1 percent fall in US economic growth will translate into a 6 percent fall in China's exports—a sector that accounts for over one third of the country's economic growth. "If the demand in the US drops further, Chinese exporters will be devastated by a rapid and a continuous fall in orders," the commerce ministry said. It also pointed to the prospect of a world slowdown. Despite interventions by central banks in US, Europe and Japan, the "panic in the credit market remains".

Huang Yiping, Citigroup's chief Asia economist, told the *Financial Times*: "I agreed with the [Chinese] government that a marked slowdown in the US would be very bad for China. We haven't seen overcapacity or a so-called hard landing in China because it has been able to export all its excess capacity until now."

The growth in China's exports to the US has already slowed significantly from 20.4 percent in the first quarter to just 12.4 percent in the third quarter—following the emergence of the US subprime crisis. A recession in the US would cause a major contraction of China's manufacturing-export sector, with the danger of huge job losses and resultant social unrest.

The impact will stretch far beyond the export sector. The same commerce ministry report explained that cuts in US interest rates—to lessen the impact of the credit crunch—came into conflict with Beijing's lifting of interest rates to rein in property and stock market speculation. Lower US rates meant speculative "hot money" would seek higher returns in China, compounding the problem of economic "overheating" and the worst inflation in a decade.

China is facing "imported inflation" as international prices for oil, minerals and other manufacturing inputs continue to rise. Like the euro, the currencies of many commodity producers are rising against the US dollar and thus the yuan, further compounding the problem.

Guo Tianyong, an economist from Central University of Finance and Economics, told *China Daily* on November 26: "Interest rate hikes [in China] would not do much to ease this, because they cannot offset the effect of international factors." In other word, China, like other national governments, is powerless to regulate the vast forces of global capital.

During a three-day visit to China late last month, French President Nicolas Sarkozy urged Chinese leaders to "arrive at currency rates that are harmonious and fair" for the euro. He warned that China had an important role to play "in not letting imbalances accumulate to a point where we won't know how to get out of them". Chinese Premier Wen Jiabao, however, rebuffed Sarkozy, saying that Beijing would only "gradually" reform its exchange regime.

To ease the pain, Beijing agreed to a $12 billion deal for nuclear reactors with France's state-owned Areva and placed a $14.8 billion order for 160 passenger jets from Airbus. The announcement came just days after Airbus CEO Thomas Enders warned that the falling dollar was a "life-threatening" issue for the company. This year, Beijing has reached an agreement with Airbus to manufacture A320 jets in China, giving the Franco-German giant a larger share in the fast growing Chinese market that used to be dominated by its US rival Boeing. Large as they are, these deals will only temporarily ease the pressure on the EU from the weak dollar.

The *Wall Street Journal* noted on November 26 that Paris, Frankfurt and Washington were apparently singing off the "same sheet of music" in demanding that China revalue the yuan. In reality, there were conflicting interests between the US and the EU, as the US dollar (and also the yuan) falls against the euro. "So when Mr. Sarkozy, in his speech, called for 'fair balance between the major currencies—the dollar, the euro, the yen or the yuan,' perhaps he wasn't just trying to soften the blow to Beijing by placing its currency in good company.... [As] the EU-China summit opens ... more comments on yuan's level are to be expected. But as the euro closes in on $1.50, one wonders when Europe's objections are going to be directed more pointedly at investors, and even toward Washington."

This is exactly what Premier Wen suggested to EU leaders, when he said that the problem of the euro "would be best put to the US financial authorities." Brussels, however, wants to establish a "mechanism" similar to the existing US-China "Strategic Economic Dialogue" as a means of pressuring Beijing on trade and currency issues. For years, the EU was largely outside the conflict between Beijing and Washington over yuan's exchange rates, but that is no longer possible.

A second *Wall Street Journal* editorial on November 29 fired a salvo back at Europe, saying the solution to its trade deficit was not protectionism, but American-style "free market" reforms. "When Mr. Mandelson wags a finger at rising Chinese exports, he's really disparaging Europe's most globalised firms," it stated, adding: "If Brussels really wants to increase its exports to China and close the trade deficit, it would make its own markets more flexible. That's why Mr. Sarkozy is trying to break the back of French labour unions. Unfortunately, labour market reforms in the EU's other big economies, Germany and Italy, are on hold for now."

Marx explained very well in Volume III of *Capital* how conflicts between rival sections of the capitalist class emerge: "So long as everything goes well, competition effects a practical brotherhood of the capitalist class, as we have seen in the case of the average rate of profit, so that each shares in the common loot in proportion to the magnitude of his share of investment. But as soon as it is no longer a question of sharing profits, but of sharing losses, everyone tries to reduce his own share to a minimum and load as much as possible upon the shoulders of some other competitor. However, the class must inevitably lose. How much the individual capitalist must bear of the loss, to what extent he must share in it at all, is decided by power and craftiness, and competition then transforms itself into a fight of hostile brothers."

The "brotherhood" of global capital is based on its mutual exploitation of the international working class. However, amid deepening global financial instability and falling profit rates, each capitalist government is trying to place the interests of its corporate elite ahead of others. The inevitable result is an increasingly ferocious dogfight between competing nation-states and the collapse of any international economic coordination. This in turn will compound the global economic crisis.