VAKIFBANK GLOBAL ECONOMY WEEKLY

Currency and Trade Wars:

United States versus China

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18 October 2010

No: 5

Vakıfbank Economic Research

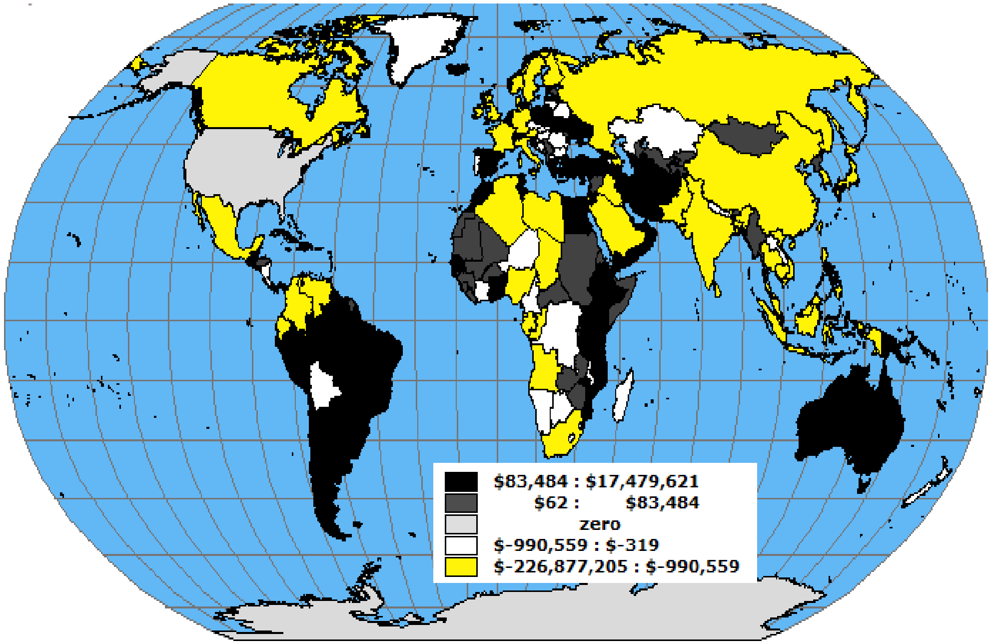
Global trade imbalances might start a currency and trade war between China and the US

Source: IMF
*Seasonally Adjusted yearly changes

- Developing countries began holding their exchange rates at undervalued rates to gain competitive advantage in foreign trade and thereby to get much power in the global economy.
- These policies resulted in high current account surpluses for developing countries and high deficits in most of the developed countries especially US with the help of high domestic consumption. The resulting global imbalances in world trade became a conflict between the surplus and deficit countries.
- In this study we analyze the latest debate on currency and trade wars between China and the US.

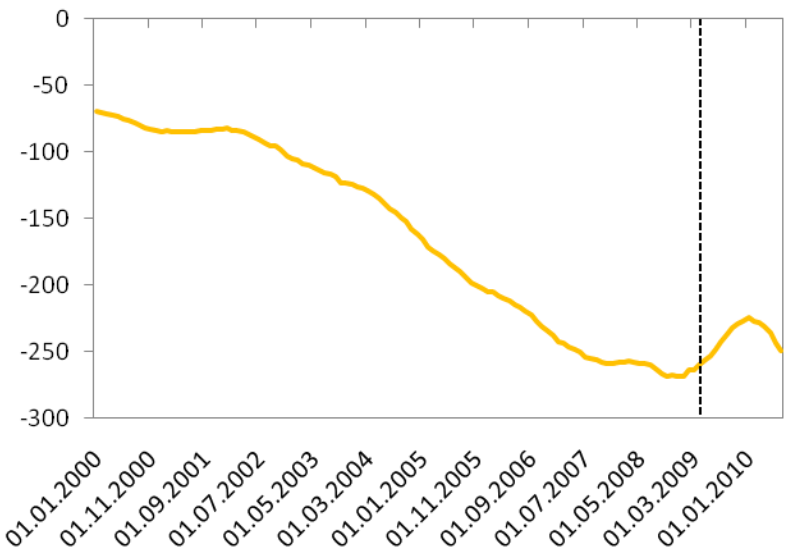
The reason why the currency and trade debate between China and the US has started

The US trade deficit (billion $)



Source: US Dept. of Commerce

US Trade Balance with China (billion $)



Source: Bloomberg

- US current account deficit which exceeded $800 billion in 2007, dropped down to $400 billion as a result of global recession.
- With the end of the recession, despite the moderate growth in US, China has began gaining its high growth performance. As a result of this, the trade balance between the two countries has been increasing since the first quarter of 2010.

High amount of trade volume between US and China might limit the application of trade barriers

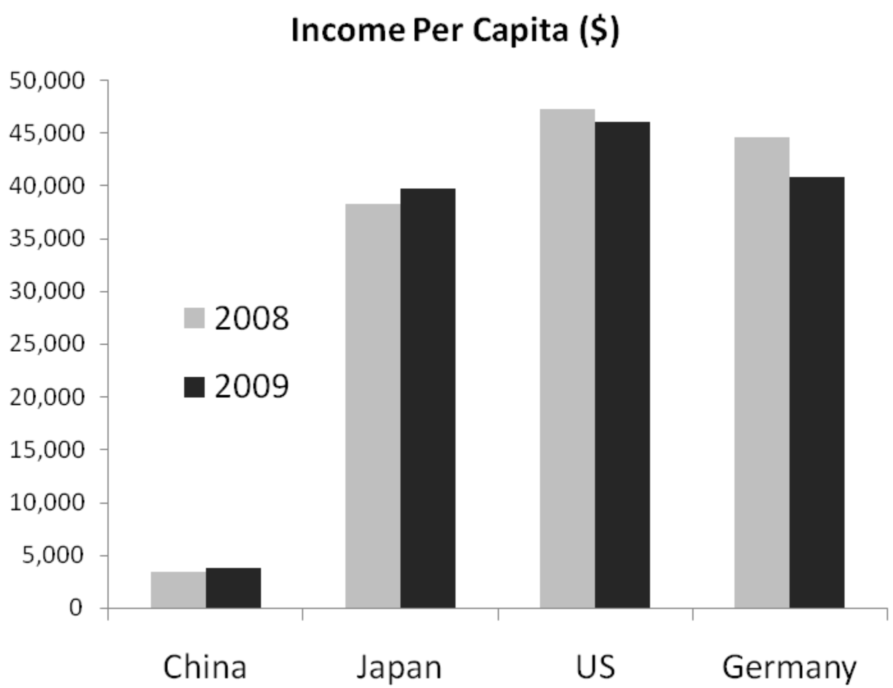
- China is the major trade partner of the US with 19% share in US imports and comes the third among the US export counterparties with 6% share.

- The intensity of the trade, might restrict the trade barriers the US might put in force against China.

- The trade in durable goods is higher than non durables and among the durables, intermediate goods trade is higher than the final goods. This might also limit the application of the trade barriers.

- Factors of production are relatively more expensive in the US. This might limit the substitution of China's export to the US.

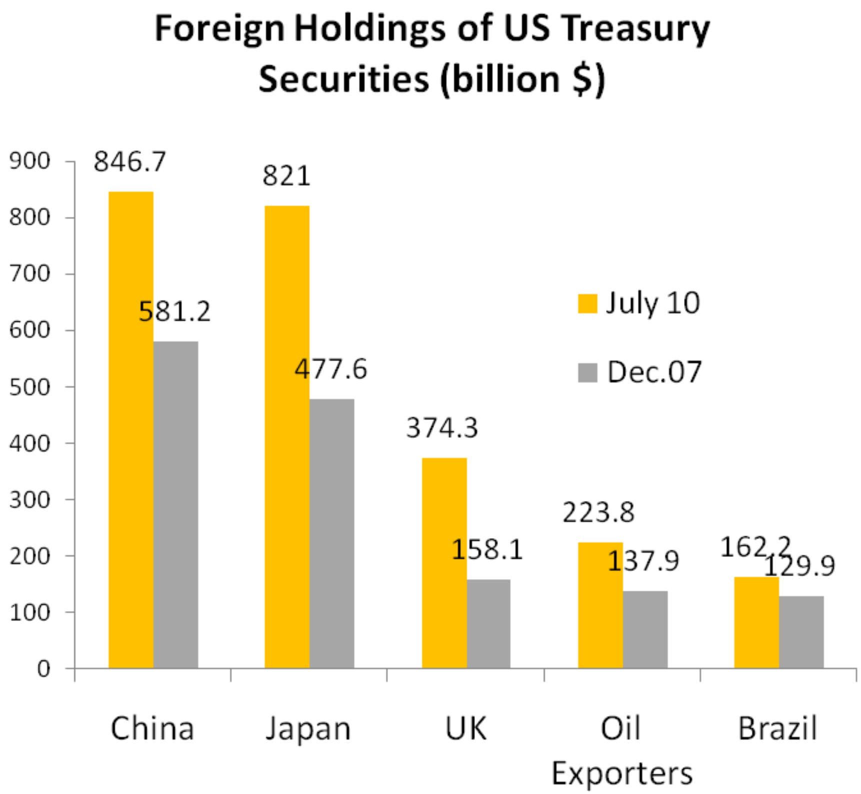
Low level of personal incomes in developing countries restrict the demand for developed country goods



Source: IMF

- Demand of developed countries for the US products is lower due to the global crises.
- The US might expect to gain market share in developing countries. But the low level of the personal income in China and other developing countries is an obstacle for the domestic consumption.

China is the major creditor of the US Treasury



Source: TIC

- China, with its foreign reserves portfolio over $2.3 trillion comes the first among all countries.
- The amount of the US dollar assets (mostly US treasuries) in China's reserves is the highest.
- The fact that China is the major creditor of the US treasury, might limit the trade barriers the US would impose on Chinese export.

Box: Protective Trade Policies

Protective trade policies are used to protect domestic producers against foreign competition. Tariffs, quotas, subsidies, currency manipulations and import barriers are the basic protective policy tools.

- **Currency Manipulation:** Governments intervene in local currencies to lower the value of their currency. This will lower the cost of exports and increase the cost of imports, and as a result trade balance will be supported. This is the most used tool since it is allowed by the international trade agreements.

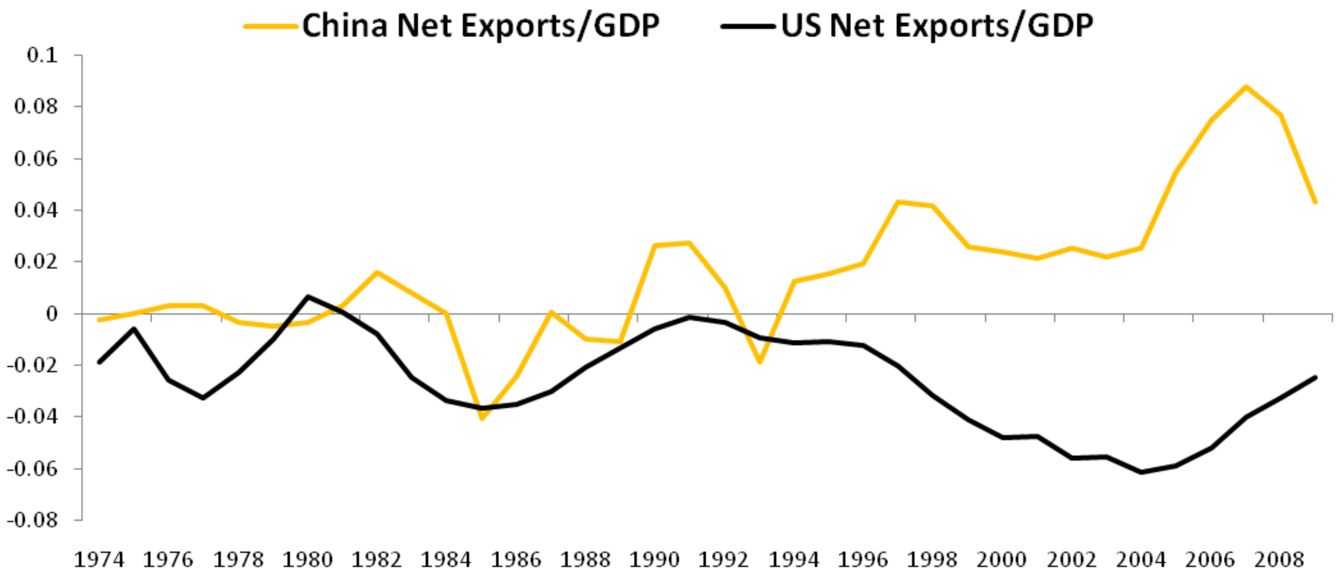
- **Tariffs:** Tax on imported goods raise the import prices in the local market.

- **Quota:** Restriction of the quantity of imported goods.

- **Subsidy:** Payments for local firms which are provided by the government.

It can be said that, the current currency policy of China is a protective policy and it provides advantage for China in international trade. This policy of China and the possibility of other protectionist policies in other countries cause concern about the future of the world economy.

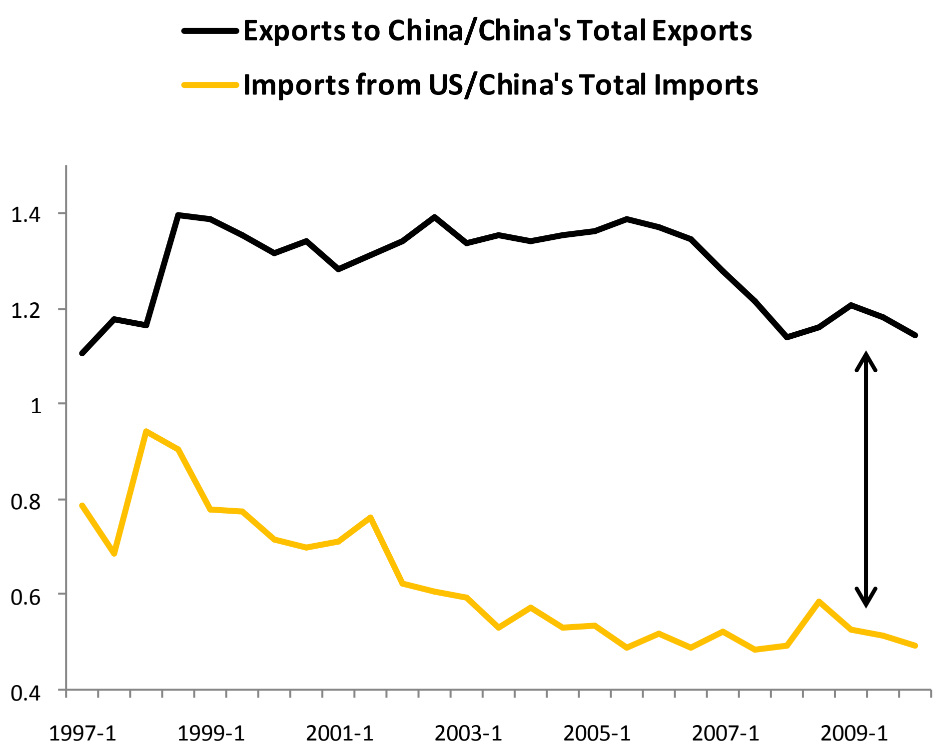
Effects of Trade Wars on China



Source: IMF

- Trade relations between the US and China have been threatened on a number of occasions this year.
- After a torrent of tariff increases by the US government, the Chinese government imposed preliminary anti-dumping duties of up to 105% on broiler chicken imports from the US on February 5.
- In the previous weeks, the US House of Representatives passed a bill that would allow tariffs to be imposed on a foreign country, especially on China.
- The share of net exports in China's GDP is higher than the share of net exports in the US GDP. That shows the impacts of trade war on China would be more devastating.

1 - Growth rate might fall



Source: Bloomberg

- Exports to the US in 2009 represent 19% of China's total exports and Chinese imports from US are less than US exports from China.

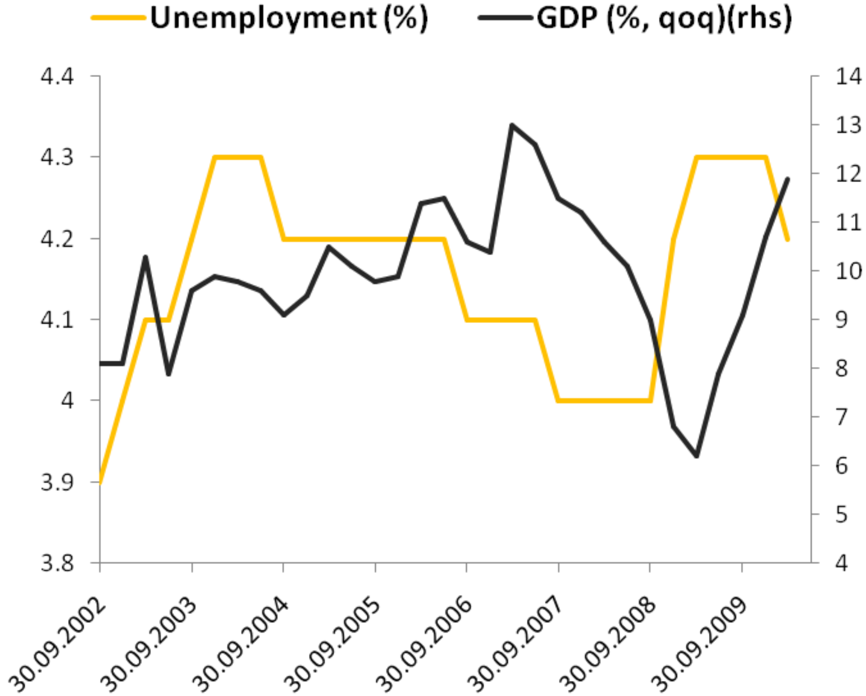
- China would likely get hurt much more than the US as an export oriented country.

- As an exporter of excess capacity, a trade war would force China to find alternative export markets. However, China has new trade relations with EM economies as decoupling debate points out.

- In the case of trade wars, Chinese real growth rate would fall by %1.9 if US will not suspend importing any goods from China.

2 - Unemployment might rise

Trade barriers on China's exports would increase unemployment in China

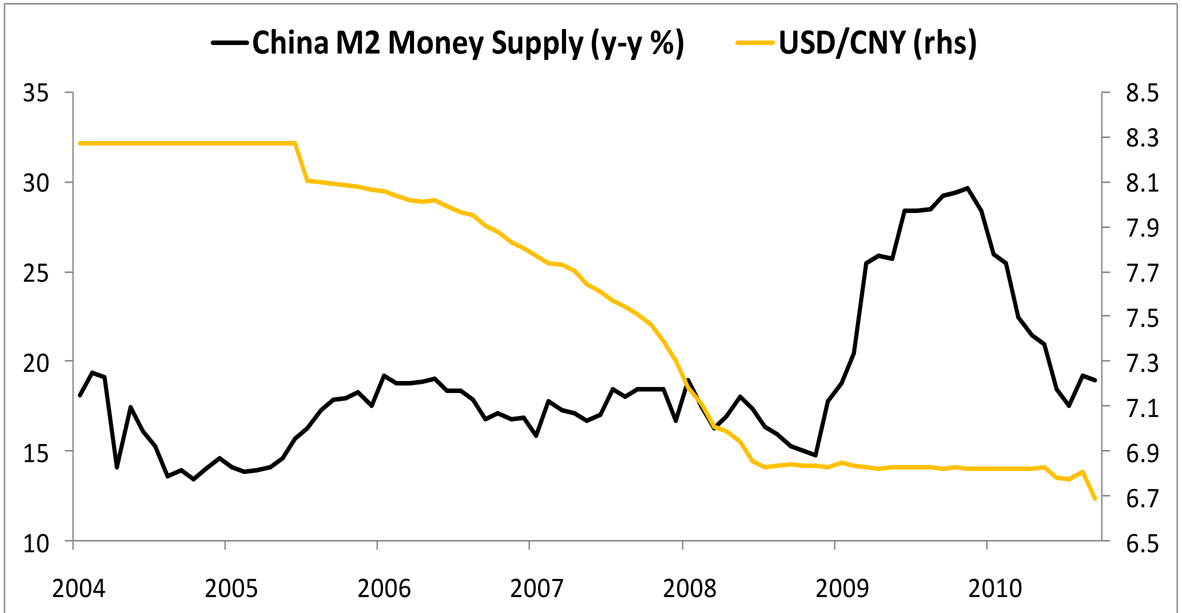


Source: Bloomberg

- China has a remarkable investment rate. With the lack of a major domestic consumption demand, equilibrium between domestic demand and domestic supply in the Chinese economy would likely to be reached through a reduction in production, rather than an increase in consumption in the case of a tariff on imported Chinese goods in the US.

- A reduction in production leads to reduction in firms' revenues and labor demand. In the case of a tariff on imported Chinese goods in the US, unemployment would rise in China.

3 - Asset price deflation risks might increase

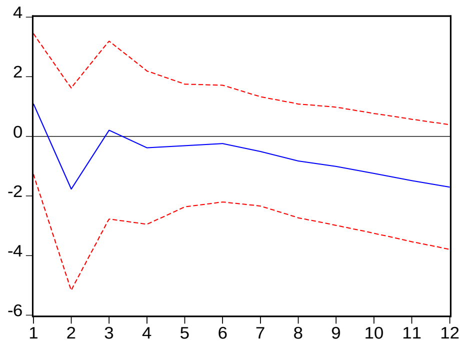


Source: Bloomberg

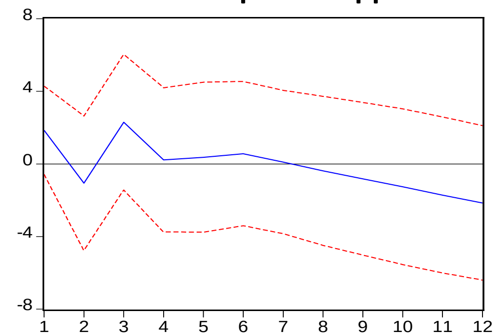
- Higher unemployment and excess supply would have a dampening effect on consumer prices.
- Reduction in trade surplus would cause a reduction in domestic liquidity, leading to a potential deflationary fall in local asset prices.
- However, excess supply may be imported by other EM economies and this effect may not be very devastating in China.

Impulse – Response Analysis

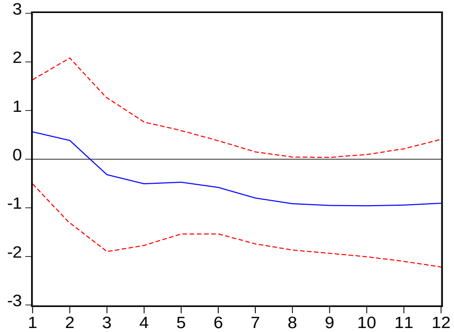
The response of China's export to appreciation in yuan



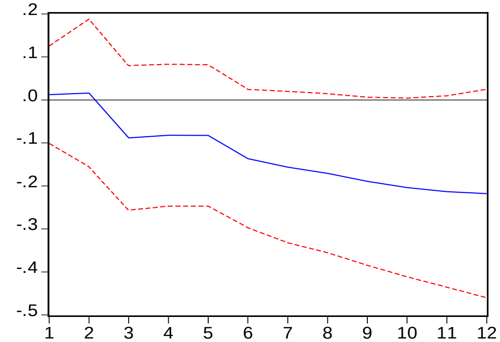
The response of China's import to appreciation in yuan



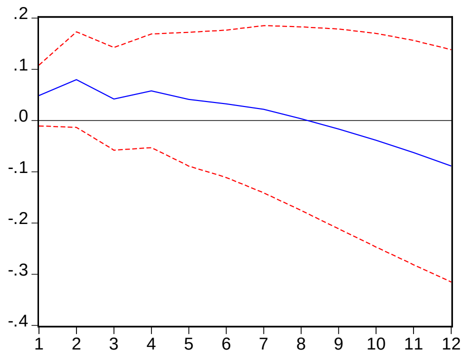
The response of China's PMI to appreciation in yuan



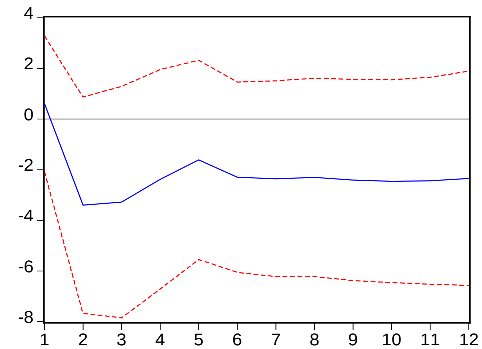
The response of US PMI to appreciation in yuan



The response of China's Inflation to appreciation in yuan



The response of US Consumption to appreciation in yuan



Impulse – Response Analysis: The Effects of Yuan Appreciation on Macroeconomic Variables

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- The model analyzes the effects of Yuan appreciation on Chinese and US economies. CNY/USD, Chinese export, import, inflation rate, PMI indexes, besides, US consumption and PMI indexes are used in the VAR model.

- The results of impulse response analysis:

  - Chinese exports respond negatively to one unit change in foreign exchange rate.

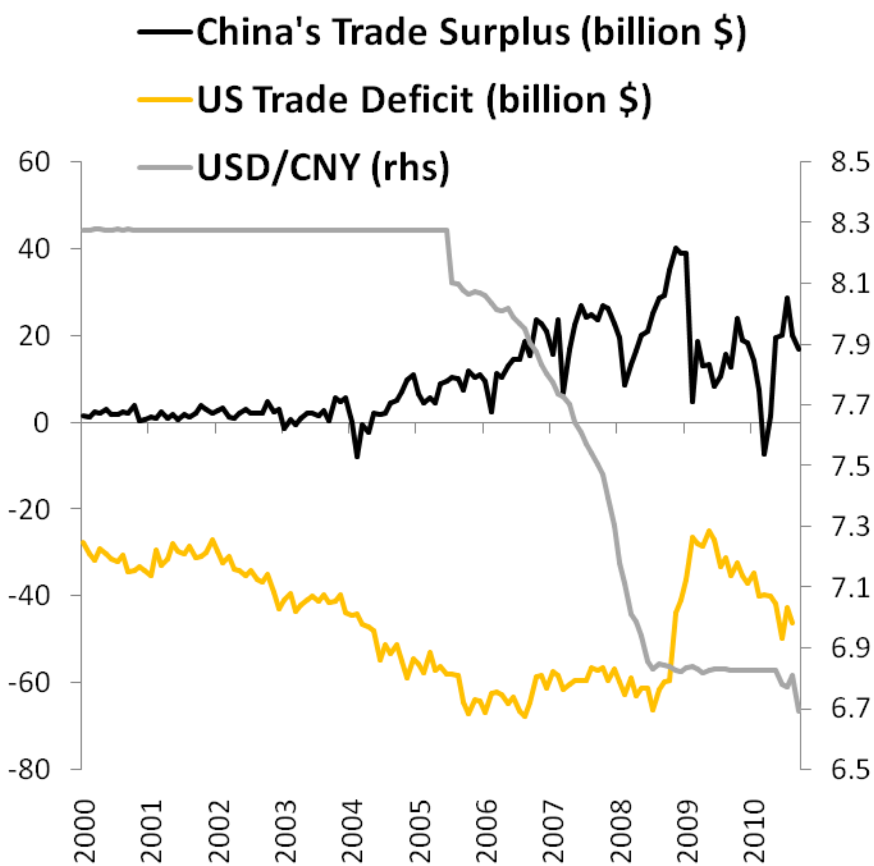
  - The response of imports is positive. However, the length of response is not as long as the length of response in exports.

  - US PMI index does not have a positive response to a shock in Yuan. This shows that the US’s argument that the appreciation in yuan contributes to its trade volumes or growth might not be true.

  - Chinese inflation rate responds negatively after fourth period.

  - Consumption in US has a negative response to unit change in Yuan appreciation.

Valuation of yuan can’t prevent the trade imbalances



Source: Bloomberg

- There is an important difference between trade balances of the US and China. While trade deficit in the US is 46.3 billion dollars in August, trade surplus in China is 20 billion dollars. Hence, it can be seen that trade imbalances in global markets result from the savings imbalances of US and China or from their domestic dynamics.

- While yuan gained 19.4% in value since 2000, US trade deficit increased 55.4%. This implies that the main reason of the global trade imbalances is not the value of yuan.

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