LA PESADILLA: UNA GUERRA
ECONÓMICA CON CHINA SI ROMNEY
SALE ELECTO PRESIDENTE DE USA

Por Stephen S. Roach,
Profesor e investigador
Principal de la Universidad de Yale

The United States and China are poised at the top of a very slippery slope. Creatures of two very different systems, they have much in common as they face critical tests of an increasingly contentious economic relationship. Both economies are at decisive transition points - old growth models have been taken to excess and must be replaced by rebalanced new models. Both governments are experiencing leadership changes - by different means, of course, but with equally important implications for the future.

This combination of mounting economic tensions and leadership transitions heightens the risks of a destabilizing shift in the relationship between the United States and China that has a nontrivial chance of sparking a trade war. In any war, there is always the saga of the itchy trigger and the first shot. With America still licking its wounds several years after the Great Crisis, there is no shortage of itchy fingers in Washington.

For the sake of argument, and in keeping with the strident rhetoric of campaign 2012, assume that the first shot is, in fact, fired by U.S. politicians. What happens next is pure conjecture - a fact-based hypothetical illustration of what's at stake if things go terribly wrong.
January 20, 2013: Newly-elected U.S. President Mitt Romney declares China guilty of currency manipulation.

True to his word as a candidate, a few hours taking the oath of office as the 45th President of the United States on January 20, 2013, Mitt Romney issued his first executive order, declaring China guilty of currency manipulation. In accordance with the Omnibus Trade and Competitiveness Act of 1988, that charge triggered immediate high-level negotiations between U.S. Treasury officials and their Chinese counterparts at the Ministry of Finance. Not surprisingly, the negotiations stalled and both parties blamed the other in vitriolic press releases.

In early February, in his first State of the Union address to the U.S. Congress, President Romney said, "Enough is enough. It is high time for China to play by our rules." Congress roared its approval and within a week, overwhelming bipartisan majorities of both houses came to the support of the newly elected president. The Defend America Trade Act of 2013 (DATA), modeled after the currency manipulation "remedies" of countervailing tariffs first proposed by Senators Charles Schumer and Lindsey Graham in 2005, was signed into law on President's Day, February 18, 2013. China was quickly deemed to be in violation of the new statute.

At that point, negotiations between the two countries took on a new urgency, escalating to the leadership level. But the new leaders in both countries - with the U.S. delegation led by President Romney and the Chinese delegation led by the country's presumptive new leaders, Xi Jinping and Li Keqiang - were in no mood for compromise. Both economies were struggling with subpar growth and attendant pressures on their labor markets. Yet both leadership teams were determined to convey a sense of strength and determination to their citizens at home. The negotiations ended in failure and a post-summit joint press conference was cancelled. In accordance with the provisions of DATA, Washington then slapped immediate tariffs of 20% on all Chinese products entering the United States.
Congress quickly passes anti-China trade legislation that results in the imposition of 20% tariffs on all Chinese shipments to the United States.

Amid howls of protest and plant shutdowns across China, Beijing declared this to be an act of economic war. It filed an immediate complaint with the World Trade Organization, not only arguing that Washington’s currency valuation metrics were dubious, but that using a currency to trigger countervailing duties was in violation of WTO rules that were framed around commodity- or sector-specific protocols. As the National People's Congress (NPC) convened in March 2013 and China's new leaders were officially sworn in, Li Keqiang used the occasion of the Premier's annual press conference to announce that China had no patience to endure a lengthy WTO dispute process that could take anywhere from two to five years to run its course.

Taking the cue from the new premier, China's Ministry of Commerce immediately announced retaliatory tariffs of 20% on all U.S. exports to China. This hit growth-starved America right between the eyes. After all, with $104 billion of American-made goods sold in Chinese markets in 2011, China had become the United States' third largest and most rapidly growing export market. With consumer demand mired in a post-bubble quagmire and the fastest growing segment of exports now under pressure, an already weakened U.S. economy was suddenly facing stiff new headwinds. Meanwhile, to add insult to injury, Wal-Mart announced average price increases of 5% - pointing to sharp tariff-induced increases in import prices that it was only able to offset partly through reduced profit margins. Other retailers followed suit and already hard-pressed American consumers hunkered down further in response. Talk of a U.S. stagflation was in the air as forecasters lowered their sights on growth but raised predictions for inflation.
Escalating retaliatory actions ensue - Chinese sanctions on U.S. exports to China, additional tariffs on Chinese imports into the U.S., and ultimately the firing of China’s "Big Bazooka" into the Treasury market.

U.S. financial markets swooned in response. The stock market was hit by the trifecta of a perfect storm - pressures on profit margins, due to tariff increases, and expectations of lower growth and higher inflation. The bond market was clobbered by the sharp deterioration in inflationary expectations and by the realization that the Federal Reserve, with its zero interest rate policy, was seriously behind the curve. A backward looking Fed offered no comfort to shell-shocked market participants. After a regularly scheduled policy meeting in June 2013, the Federal Reserve reaffirmed its commitment to keep its policy benchmark interest rate near zero through 2014, and even dangled the possibility that it might pick up where a failed QE3 had left off and consider yet another round of quantitative easing, QE4. Yields on 10-year Treasuries moved back above 4% in response, and stocks came under further downward pressure.

Feeling the heat from financial markets, Washington turned the dial further on newly imposed anti-China trade sanctions. Senator Charles Schumer went on national television on July 4, 2013 and said, "Enough is enough. We've carried the big stick for years. Democrats and Republicans stand together in believing now is the time to use it." Building on Washington's newfound bipartisanship, President Romney agreed and, borrowing a page from the script of President Hoover in the 1929 run-up to passage of the Smoot-Hawley tariffs, called Congress back from its Independence Day holiday into a special session to consider the China problem. By unanimous consent, the Congress quickly passed an amendment to DATA - upping the just-imposed countervailing tariffs on China by another 10 percentage points. Borrowing from his 2007 book, Schumer commented after the action, "The United States is determined to fight for the middle class - if we have to, one family at a time.[1]"
At that point, an indignant China turned to its own version of the Big Bazooka. Owners of $1.1 trillion of Treasury securities, the biggest foreign buyer of U.S. debt, China was nowhere to be seen at Treasury's August 2013 regular "quarterly refunding" auction. Treasury had announced intentions to sell $25 billion of 10-year notes and was counting on the State Administration of Foreign Exchange to purchase at least $4 billion of those securities. SAFE had been given special direct-dial privileges by Treasury officials, allowing it to circumvent Wall Street dealers and go directly to the issuer. The line went dead when it was activated in the Treasury dealing room on August 8, 2013. Long-term interest rates spiked, and within two weeks yields on 10-year Treasuries had pierced the 7% threshold. At the same time, the dollar plunged and the U.S. stock market, which had already corrected by 20% in the first half of 2013, gapped down by another 10% by the end of August.

Financial markets are roiled, as stocks plunge in excess of 30% and yields on 10-year U.S. Treasuries exceed 7%. The US and China slip back into recession, as does the rest of the global economy.

Just like that - the so-called exorbitant privilege of the safe-haven asset had vanished into thin air. When asked at a press conference why China would willingly engage in actions that would undermine the value of over $2 trillion in Treasuries and other dollar-based holdings of foreign exchange reserves, Zhou Xiaochuan, retiring Governor of the People's Bank of China, said, "This is not about risk-adjusted portfolio returns. We are defending our people against an act of economic war." When queried further as to whether China would up the ante on its "buyer strike" and actually begin to sell its massive holdings of Treasuries, Zhou said simply, "Only if we have to."

By the autumn of 2013, there was little doubt of the severity of renewed recession in the United States. Lacking in saving, trade sanctions on China backfired. Ever
needy of foreign capital, the other 87 bilateral pieces of America’s massive multilateral trade deficit were rearranged like deck chairs on the Titanic. Chinese sourcing was redirected to other foreign producers, and most were higher cost producers than China - effectively taxing middle-class families all the more. All this was a painfully obvious confirmation of a horrific policy blunder - that there is no bilateral fix for the multilateral trade imbalance of a saving-short U.S. economy. Contrary to yet another of Washington's hollow promises, long beleaguered American workers paid the steepest price of all, as the unemployment rate shot back up above 10%.

Hopefully, this is all just a bad dream. But the chilling legacy of Reed Smoot and Willis Hawley cautions otherwise.

In China, growth had slipped below the dreaded 6% threshold, and the new leadership was rolling out yet another pro-active investment stimulus for a still unbalanced and unstable Chinese economy. Structural reforms were put on hold and China’s long-awaited pro-consumption rebalancing stalled. As the global economy slipped back into renewed recession, the Great Crisis and Recession of 2008-09 suddenly looked like child’s play. And globalization, itself, was teetering on the edge.

No, this hasn’t happened - at least not yet. Hopefully, saner minds will prevail, allowing the U.S. and China to step back from the brink. But this bad dream comes with an important lesson: Both economies continue to struggle - trapped in antiquated growth models that are not delivering the prosperity that politicians continue to promise. Political transitions and tough economic climates can make for a very treacherous combination. Under such circumstances, events can spin out of control very quickly. Is this one of those times? The risks of a trade war could well hang in the balance.
History warns us never to say never. Such is the chilling legacy of Senator Reed Smoot and Representative Willis Hawley, architects of America's worst economic policy blunder. Bad dreams can - and have - come true.