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THE US - CHINA "TRADE WAR": The War Nobody Can Win

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Abstract

The main aim of this paper is to analyze US-China trade relations and the so-called "trade war" between the two countries. As a first step, we will look at the trade relations between the two countries and explain why President Trump is eagerly following a protectionist trade policy toward China and fighting with some of America's oldest trading partners. Finally, we will focus on the possible effects of the trade war on both countries' economies. The US and EU governments and other leading economic actors have underestimated China's rapid economic growth and were unprepared for the dawning of new economic power. Forty years later, the first reaction to new economic power and its expansionary economic policy came from US President Donald Trump and later by the EU and Germany. The trade conflict between the United States and China has not yet affected trade flows, which are still growing in favour of China. Despite the Trump administration's penalty tariffs on China, the US trade deficit in goods with the country could not be reduced at all. Obviously, the initial round of tariffs imposed by the United States has not stopped Chinese firms from exporting more goods to the United States in the last year. For the time being, nobody can make any predictions about the outcome of the trade war. It seems nobody can easily win this war, and it will be costly. The continuation of the trade war between China and the United States will more or less cause strong economic turbulence in every nation as long as both Trump and Xi hold on tight to their trade policies and do not be-have as responsible statesmen. As a final statement, to borrow words from Paul Krugman, "at this rate, we may have to wait for a new president to clean up this mess, if she can."

Key Words: China, USA, Trade War, Mercantilism, Exchange Change Regime.

JEL Classification: E6, F1, F4, F6, N1, 051,053.

Without fanfare—indeed, with some misgivings about its new status—China has just overtaken the United States as the world's largest economy. This is, and should be, a wake-up call—but not the kind most Americans might imagine…" Nobel Prize-Winning Economist Joseph Stiglitz.[1]

1. Introduction

The main aim of this paper is to analyze US-China trade relations and the so-called "trade war" between the two countries. As a first step, we will look at the trade relations between the two countries and explain why President Trump is eagerly following a protectionist trade policy toward China and fighting with some of America's oldest trading partners. Finally, we will focus on the possible effects of the trade war on both countries' economies.

If we look at European economic history between the 15th and late 18th centuries, we can see that due to the expansion of the European market in the early stages of commercial capitalism and colonialism, mercantilist policies were favored by leading European nation-states in order to promote their national economies by encouraging exports and restricting imports for creating trade surplus. It was a common belief in Europe that "exports create wealth." It was not until 1776 when Adam Smith published his famous book *Wealth of Nations*, which sharply criticized mercantilist policies and explained the benefits of international free trade with help of his "Theory of Absolute Advantages," that European nations began to move away from these policies.

Following Smith's work, another well-known British economist, David Ricardo, published his book *On the Principles of Political Economy and Taxation* in 1817 and presented his "Theory of Comparative Advantage," which has remained fundamentally unchallenged until today. Ricardo also defended the advantages of free trade for Britain in his work "Theory of Corn Law." The Industrial Revolution, which began in Great Britain, gave Britain the opportunity to benefit from the advantages of international free trade, putting these principles in action and expanding the market economy in the late 19th century and the beginning of the 20th century.

After the Second World War, the US and the international organizations founded and largely financed by the US such as the World Bank, OECD, IMF, and WTO were built on the principles of economic liberalism, free trade, and the market economy. Over time developing countries, command economies, and former communist states have all been advised by these institutions to accept the rule of the games based on free trade and the market economy within the framework of the "Washington Consensus."[2] From 1945 until today, the US has been the greatest economic power, dominating and reshaping the world economy in close cooperation with multinational institutions. It has defended and benefitted from the free market economy and free trade in international economies.

[1] https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-chinahe, see Office of the United States Trade Representative (USTR).

[2] Original Principles of the Washington Consensus. These are the ten specific principles originally set out by John Williamson in 1989: see https://www.intelligenteconomist.com/washington-consensus/

2. China as a Rising Economic Power in the 21st Century

In the last 40 years, an unpredicted event has occurred in the global economy. The Chinese "economic miracle" began in December 1978 with Deng Xiaoping's deep-seated strategic re-orientation and the opening of the Chinese economy to the world market. China's policy of reform and its opening to international competition have brought the previously closed, economically unimportant, poor country into the top group of the world economy. Contrary to free-market economies, the People's Republic of China has established its own political, economic, and social model of state capitalism, in which the economy is state-led and consequently controlled by the state.

Today, both the US and China are the primary economic and military (super) powers. For example, the European Union and Japan are economic powers but not military powers; Russia is a military power but not an economic power.

China is without a doubt the chief rising power of the 21st century, which is called the "Chinese Century." The US and EU governments and other leading economic actors have underestimated China's rapid economic growth and were unprepared for the dawning of new economic power. Forty years later, the first reaction to new economic power and its expansionary economic policy came from US President Donald Trump and later by the EU and Germany.

During his 2016 election campaign, Donald Trump promised to make trade fairer for the US in order to stop the "unfair transfers of American technology and intellectual property to China" and protect American jobs. President Trump claimed, "China has stolen American technology, American jobs, and played a dirty game when it comes to restricting access to the Chinese market for US firms."[3] There is a coalition of politicians and businesses within the US that believe, "… China has a deliberate strategy to push America back and impose its will abroad, and that there needs to be a strong America response."[4]

On September 17, 2018, Trump tweeted that "Tariffs have put the U.S. in a very strong bargaining position, with billions of Dollars, and Jobs, flowing into our Country - and yet cost increases have thus far been almost unnoticeable. If countries will not make fair deals with us, they will be "Tariffed!"[5] Trump added in his next tweets, "When a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win."[6]

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3 Calvin Miao, The US- China Trade War, https://sites.utexas.edu/longhornglobalbiznet/the-us-china-trade-war

4 According to Economists, the coalition covers Team Trump, the national-security hawks in Congress, Pentagon chiefs and the bosses of spy agencies, in civil society, the coalition also includes religious conservatives, human rights advocates, labour unions and old –school protectionists. See The Economist, "Briefing: China and America ", October, 20th- 26th 2018, p.24.

5.https://twitter.com/realDonaldTrump/status/1041630722413527040Trump

6 Trade Wars and their Effect on the Economy and You Why Trade Wars Are Bad and Nobody Wins, https://www.thebalance.com/trade-wars-definition-how-it-affects-you-4159973

3. Trade Relations Between the US and China

Since the beginning of his campaign, Donald Trump has been heralding the policy of "America First," which involves a trade policy based on nationalism and protectionism. Trump's America First policy envisions the resurgence of mercantilist policies in the 21st century. He supports tariffs, duties, and other forms of commercial trade policies to give domestic industries a comparative advantage. He has initiated three tariffs: a global tariff on steel, a tariff on European autos, and tariffs on Chinese imports. Nobel Prize Winner Economist Paul Krugman describes his trade policy as follows:

> … Trump really is a Tariff Man. Some naïve souls may still have been hoping that he would learn something from the failure of his trade policy so far… But no: it's pretty clear now that he refuses to give up on his belief that trade wars are good, and easy to win; his plan is to continue the beatings until morale improves…[7]

3.1 Foreign Trade Policies: Theoretical Approach

Trade (or foreign trade) policies in the broad sense aim to protect domestic industries from international competition. Trade policies can usually be divided into two main groups: tariff and non-tariff trade policies. Tariff policies consist of import taxes (tariffs), which protect domestically located uncompetitive industries from international competition at the expense of domestic consumers and in favor of local producers and government budget revenues.

Import quotas are implemented to limit the amount of imported goods. In turn, these policies protect domestic industries at the cost of consumers. The surplus created by the import restrictions is divided between producers and the import firms, which are allowed to import a certain number of commodities from other countries with import licenses.

The third type of protectionist policy concerns the direct or indirect export of subsidies in the form of export credits, direct subvention, tax reduction, and indirectly, research and development subsidies. The basic goal of this trade policy is to make domestic industries more competitive in international markets. The agricultural subsidy is one of the most commonly practiced export subsidies in the US and EU. Accordingly, the US federal government and Common Agricultural Funds in the EU support farmers financially.

These policies allow producers/exporters to sell their products at a lower price abroad than at home. Therefore, domestic consumers have to pay higher prices for the same good at home compared to foreign consumers. To negate this effect, the country in question can increase export revenues with the help of export subsidies. However, the government must finance subsidies through the public budget at the expense of domestic taxpayers.

The last protectionist measure concerns the exchange rate policy. The real exchange rate indicates the international competitiveness of the national economy.[8] There are two ways to increase a country's international competitiveness through the exchange rate: first, depreciating

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[7] Paul Krugman, "Trump's China Shock: : What the Heck is Going on?, The New York Times, Aug.5.2019. https://www.nytimes.com/2019/08/05/opinion/trumps-china-shock.html

[8] Real Exchange rate is defined as Pus/P China x Nominal exchange rate USȘ/yuan

or devaluing the national currency against hard currencies at the flexible exchange or fixed rate systems. The second strategy is to reduce the cost of production or to increase overall productivity through efficient use of resource allocation. For example, China allows for the fluctuation of its currency, the yuan,[9] against the US dollar. It devalues/revalues the currency when needed to keep its export prices competitive.

US-World Trade[10]

Key Facts:

- Since 1975, the United States has had the world's largest trade deficit. The deficit in goods and services was $621 billion in 2018. Imports were $3.1 trillion and exports were only $2.5 trillion. In 2018, the U.S. trade deficit in goods alone was $891 billion. The United States exported $1,672 trillion in goods.[11]

- The biggest categories of its exports were commercial aircrafts, automobiles, and food. The largest categories of imports were automobiles, petroleum, and cell phones.[12]

- Top five trading partners with trade deficits: China - $660 billion traded (30%) with a $419 billion deficit (63%); Canada- $617 billion traded (27%) with a $20 billion deficit (3%); Mexico - $611 billion traded (26%) with an $81 billion deficit (12%); Japan- $218 billion traded (9%) with a $67.6 billion deficit (12%) and Germany - $184 billion traded (8%) with a $68.2 billion deficit (11%)[13] .

[9] China's national currency is yuan. Chinese people call it's called the renminbi, which means "the money of the people." The renminbi is also the official name for the currency, while the yuan is a unit of the currency. It's pronounced as '*yoo-ahn'*.

[10] Main source of data: US Trade Deficit by Country, With Current Statistics and Issues, https://www.thebalance.com/trade-deficit-by-county-3306264 Exhibit 8. U.S. Imports of Goods by End-Use Category and Commodity, https://www.census.gov/foreign-trade/Press-Release/current_press_release/exh8.pdf.

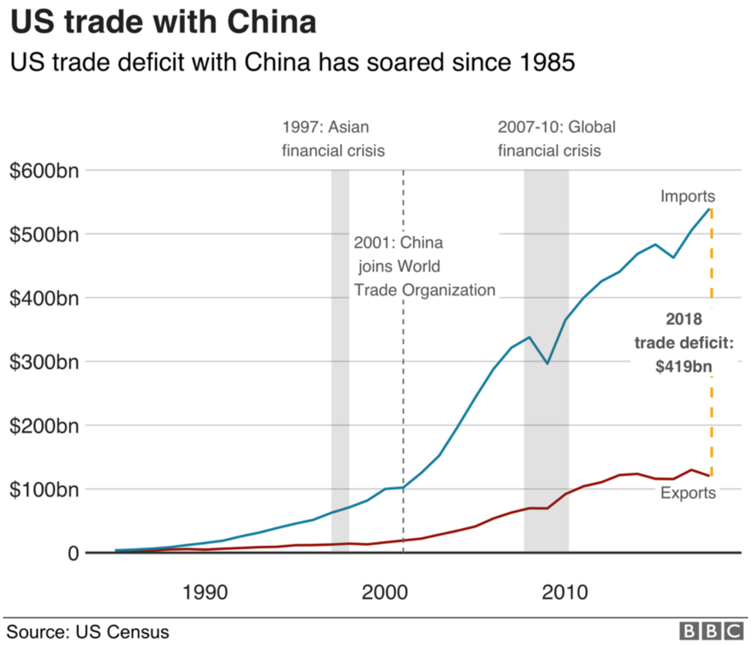
[11] https://www.census.gov/foreign-trade/Press-Release/current_press_release/exh1.pdf

[12] Kimberly Amedeo,"US Trade Deficit by Country, With Current Statistics and Issues", https://www.thebalance.com/trade-deficit-by-county-3306264

[13] Percentages based on the total volume of goods traded, and the total deficit amounts for the top 5 U.S. partners. See https://www.thebalance.com/trade-deficit-by-county-3306264.

3.2 US-China Trade Facts[14]

Figure 1: Trade in Goods between China and US



Source: https://www.bbc.com/news/business-48196495

- Figure 1 shows that the trade deficit between the US and China has been widening and expanding to the disadvantage of the American economy. US goods and services trade with China totaled an estimated $737.1 billion in 2018. Exports were $179.3 billion; imports were $557.9 billion. The US goods and services trade deficit with China was $378.6 billion in 2018.

- China is currently the United States' largest goods trading partner, with $659.8 billion in total (two-way) goods trade during 2018. Goods exports totaled $120.3 billion; goods imports totaled $539.5 billion. The US goods trade deficit with China was $419.2 billion in 2018.

- By far, the largest US trade deficit by country is with China. In 2018, the US trade deficit with China was $419 billion. The United States imported $540 billion, primarily in computers, cell phones, and apparel. Much of this is manufactured in China by US companies but is still considered imported. US companies exported $120 billion to China. Most of this was commercial aircrafts, soybeans, and automobiles. (See Figure 2)

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[14] Main source of US-China trade data is based on The People's Republic of China, Office of the US Trade Representative, https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

- Trade in services with China (exports and imports) totaled an estimated $77.3 billion in 2018. Services exports were $58.9 billion; services imports were $18.4 billion. The US services trade surplus with China was $40.5 billion in 2018.

- According to the Department of Commerce, US exports of goods and services to China supported an estimated 911,000 jobs in 2015 (601,000 supported by goods exports and 309,000 supported by services exports).[15]

Figure 2: US Trade Deficit and China

Source: https://www.thebalance.com/u-s-china-trade-deficit-causes-effects-and-solutions-3306277

Exports[16]

- China was the United States' third largest goods export market in 2018.
- US goods exported to China in 2018 were $120.3 billion, down 7.4% ($9.6 billion) from 2017 but up 72.6% from 2008. US exports to China are up 52.7% from 2001 (pre-

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[15] Main source of trade data :https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

[16] Ibid. https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

WTO accession). US exports to China accounted for 7.2% of overall US exports in 2018.

- The top export categories (2-digit HS) in 2018 were aircrafts ($18 billion), machinery ($14 billion), electrical machinery ($13 billion), optical and medical instruments ($9.8 billion), and vehicles ($9.4 billion). (See Figures 2 and 3.)

- China is America's biggest and the most important trading partner. The United States' main imports from China were computers and accessories, cell phones, and apparel and footwear. A lot of these imports are from US manufacturers that send raw materials or intermediate goods to China for low-cost production. Chinese producers convert them into finished goods then export them to the United States, which are counted as imports to the United States from China. In fact, a lot of China's so-called "exports" are for American companies.

- US exports of agricultural products to China totaled $9.3 billion in 2018, the US's fourth largest agricultural export market. Leading domestic export categories include: soybeans ($3.1 billion), cotton ($924 million), hides & skins ($607 million), pork & pork products ($571 million), and coarse grains (e.g., corn) ($530 million).

- Half of all Chinese imports are raw materials and intermediate products used by US producers to make final goods. They send input goods to China for low-cost assembly. Then, the finished goods are shipped back to the United States and are registered as imports from China. The tariffs raise their costs, forcing firms to either raise prices or lay off workers.

- China is the world's number one exporter. It mostly produces labor-intensified consumer goods at lower costs than in other countries. China has a lower cost of labor in comparison to the US, which allows its companies to reduce the cost of production. American companies cannot compete with China's low costs, so they lose US jobs in the consumer goods sector. Of course, American consumers want the same goods for the lowest prices. Most are not willing to pay more for "Made in America."

- US exports of services to China were an estimated $58.9 billion in 2018, 2.2% ($1.3 billion) more than 2017, and 27.2% greater than 2008 levels. This is roughly a 99.7% increase from 2001 (pre-WTO accession). Leading services exports from the US to China were in the travel, intellectual property (trademark, computer software), and the transport sectors.

Figure 3: The Composition of Exported and Imported Goods between China and the US: One-Sided Trade

Source: https://www.marketwatch.com/story/heres-all-the-stuff-the-us-imports-from-china-thats-causing-a-huge-trade-deficit-2018-03-23

<u>Imports</u>[17]

- China was the United States' largest supplier of goods imports in 2018.

- US goods imports from China totaled $539.5 billion in 2018, up 6.7% ($34.0 billion) from 2017, and up 59.7% from 2008. US imports are up 42.7% from 2001 (pre-WTO accession). US imports from China accounted for 21.2% of overall US imports in 2018.

- The top import categories (2-digit HS) in 2018 were electrical machinery ($152 billion), machinery ($117 billion), furniture and bedding ($35 billion), toys and sports equipment ($27 billion), and plastics ($19 billion).

- US imports of agricultural products from China totaled $4.9 billion in 2018: the third largest supplier of agricultural imports. Leading categories include processed fruits and vegetables ($1.2 billion), fruit and vegetable juices ($393 million), snack foods ($222 million), spices ($167 million), and fresh vegetables ($160 million).

- US imports of services from China were an estimated $18.4 billion in 2018, 5.5% ($963 million) more than 2017, and 68.3% greater than 2008 levels. This was up

[17] Main source trade data: Ibid, https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

roughly 41.4% from 2001 (pre-WTO accession). Leading services imports from China to the US were in the transport, travel, and research and development sectors.

Trade Balance[18]

- The US goods trade deficit with China was $419.2 billion in 2018, an 11.6% increase ($43.6 billion) over 2017. Figure 3 shows that the trade in goods between China and US is one-sided, one-way trade.

- The United States had a services trade surplus of an estimated $41 billion with China in 2018, up 0.8% from 2017.

Investment[19]

- US foreign direct investment (FDI) in China (stock) was $107.6 billion in 2017, a 10.6% increase from 2016. US direct investment in China is led by manufacturing, wholesale trade, and finance and insurance.

- China's FDI in the United States (stock) was $39.5 billion in 2017, down 2.3% from 2016. Manufacturing, real estate, and depository institutions lead China's direct investment in the US.

- Sales of services in China by majority US-owned affiliates were $55.1 billion in 2016 (latest data available), while sales of services in the United States by majority China-owned firms were $8.3 billion.

3.3 Public Debt

The US not only has a huge trade deficit with China, but also China owns 28% of US public debt to foreign countries. China is the largest foreign holder[20] of the US Treasury (financial assets).[21] In May 2019, it owned $1.11 trillion in Treasury assets.[22] On February 11, 2019, the US debt exceeded $22 trillion. This means that the debt/GDP ratio is now 108 percent.[23] One of the main reasons why China buys US debt is to support the value of the dollar.[24] This is because China fluctuates its currency, the yuan, according to the US dollar; it devalues the currency when needed to keep its export prices competitive.

18 Ibid, https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

19 İbid, https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china

20 https://ticdata.treasury.gov/Publish/mfh.txt

21 Treasury Bills, Notes, and Bonds With Examples of How They Work, by Kimberly Amedeo,

22 https://ticdata.treasury.gov/Publish/mfh.txt

23 Kimberly Amedeo, "Tramp and National Debt", https://www.thebalance.com/trump-plans-to-reduce-national-debt-4114401.

24 The value of the U.S. Dollar is measured in three ways: Exchange rates, Treasury notes, and foreign exchange reserves. See Kimberly Amedeo, https://www.thebalance.com/value-of-us-dollar-3306268.

Between 2014 and 2016, the dollar's strength increased by 25%. The rise forced China to devalue the yuan against the US dollar. (See Figure 4) If the value of dollar would appreciate against the yuan in the short term, the value of the yuan would be devalued.

4. Trade war between the US and China

A trade war is created when a nation-state excessively protects its economy through foreign trade policies, e.g., tariffs and non-tariff barriers, against other economies. If foreign countries react by implementing similar trade policies, then a trade war breaks out among the world economies, resulting in a domino effect.

In a trade war, world trade and the global economy are negatively affected. For example, The Smoot-Hawley Act is the Tariff Act of 1930 that was put in force to protect US farmers from agricultural imports by increasing 900 import tariffs by an average of 40% to 48%. This decreased global trade by 65% and contributed to deepening the Great Depression and the outbreak of the Second World War.[25]

Trump decided to change the present world trade order by imposing unilateral tariffs to justify what he calls "unfair trade practices by China, the European Union and other major trading partners of the United States."[26]

Actually, President Tramp wants to reduce the $621 billion US trade deficit by reducing the import of goods through import tariffs and quotas. He is not only intended to increase domestic production of imported goods under the motto "Made in America," but also aims to increase the government budget revenues and create new jobs, or at least keep the present jobs of import-competitive firms in the United States. [27]

President Trump is playing his trade strategy against China like a professional poker player. If he cannot reach his aim and is not satisfied with the results of the negotiations process with China, then he increases the bet to enforce its counter-player to accept his conditions or to leave the table. Trump is increasing the pressure on trade talks that are underway.

In addition to reducing the trade deficit, Trump wants to control US technology transfers to Chinese companies. China requires foreign companies that want to sell products in China to share their trade secrets. The administration has also asked China to stop subsidizing the ten industries prioritized in its "Made in China 2025" plan. These include robotics, aerospace, and

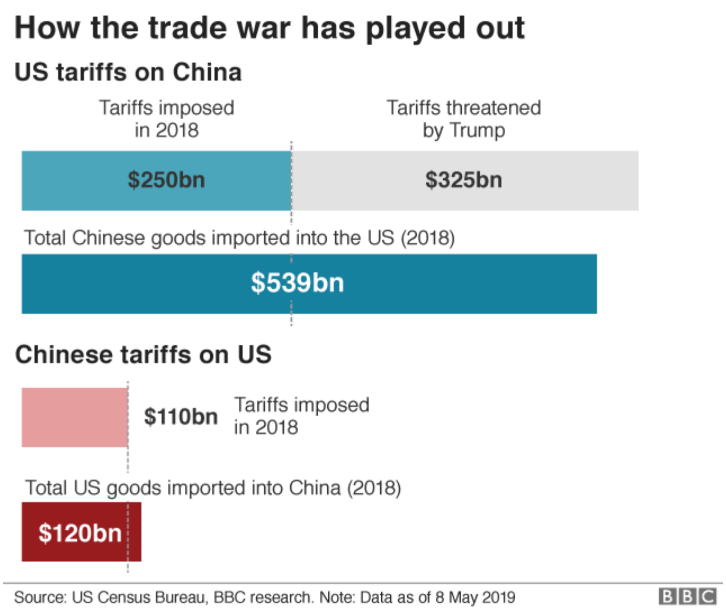
[25] For detailed information on The Smoot-Hawley Act is the Tariff Act of 1930, see "What the Smoot Hawley Act Can Teach Protectionists Today", https://www.thebalance.com/smoot-hawley-tariff-lessons-today-4136667.

[26] Factbox: Tariff wars - duties imposed by Trump and U.S. trading partners, https://www.reuters.com/article/us-usa-trade-tariffs-factbox/factbox-tariff-wars-duties-imposed-by-trump-and-us-trading-partners-idUSKCN1SJ1ZJ

[27] See for the President Donald Trump's Economic Plan, https://www.thebalance.com/donald-trump-economic-plan-3994106

software. As China plans to be the world's primary artificial intelligence center by 2030, it is unlikely to agree to those demands.[28]

Figure 4: US-China Trade War Major



Source: https://www.bbc.com/news/business-481964

4.1 The US-China Trade War: A Timeline[29]

As Figure 4 shows:

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[28] Attune Financial Planning, May, 20,2019 https://attunefp.com/blog/trade-wars-are-not-easy-to-win

[29] See for detailed information: The US-China Trade War Timeline: https://www.china-briefing.com/news/the-us-china-trade-war-a-timeline

Some important events from 2019:

August 13, 2019 – US and China agree to talk again in two weeks

August 13, 2019 – US delays tariffs on certain products and removes items from the list

August 6, 2019 – Chinese companies suspend new US agricultural product purchases

August 6, 2019 - US declares China is a currency manipulator

May 23, 2019 - Trump subsidized farmers $16 billion in in aid to partially compensate for their losses. He gave them $12 billion in 2018.

August 1, 2019 – Trump says US will impose 10 percent tariffs on another US$ 300 billion of Chinese goods starting September 1

July 30-31, 2019 – Shanghai trade talks end with little progress being made

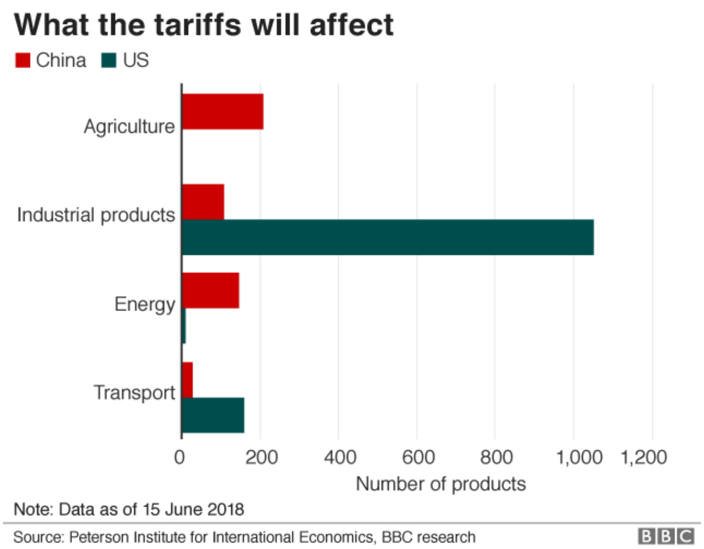
July 16, 2019 – Trump threatens tariffs on US$325 billion of Chinese goods (despite promises not to), new member on China's negotiating team

- Total US tariffs applied exclusively to Chinese goods totaled $250 billion. These tariffs cost the average household $419 per year.[30]

- On May 20, 2019, Trump imposed a fourth tariff. He raised tariffs to 25% on $200 billion worth of goods. It is estimated these tariffs would cost the average household $831 a year.[31]

- Total Chinese tariffs applied exclusively to US goods totaled $110 billion. Trump threatened to expand that tariff to an additional $325 billion of Chinese imports. This would raise prices on all Chinese imports. On June 29, 2019, Trump delayed the proposed tariffs to encourage renewed trade talks with China.

Figure 5: Impacts of tariffs on economic sectors in both countries



Source: https://www.bbc.com/news/business-44728166

- Figure 5 clearly indicates that China is imposing import tariffs largely on agricultural products and mechanical parts for the energy sector, whereas the US is raising tariffs on a large number of industrial products and resources.

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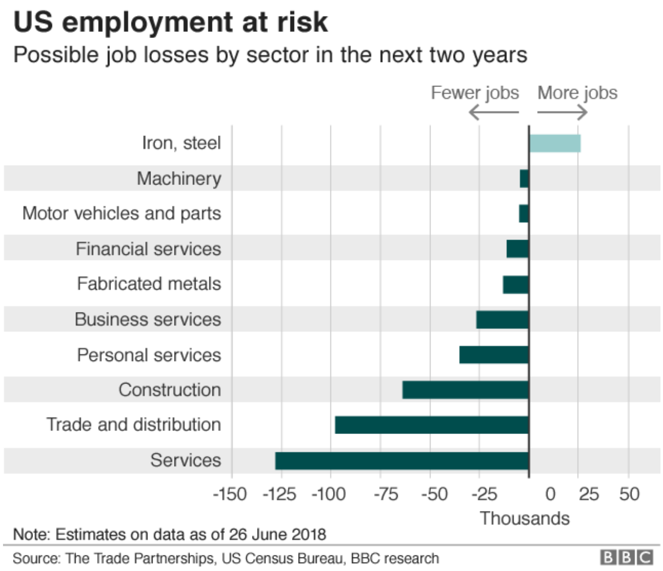
[30] Mary Amiti Stephen J. Redding David Weinstein, The Impact of the 2018 Trade War on U.S. Prices and Welfare, Working Paper 25672 http://www.nber.org/papers/w25672

[31] Mary Amiti Stephen J. Redding David Weinstein, ibid.

Figure 6: How Does the Trade War Affect the Labor Market in the United States



Source: https://www.bbc.com/news/business-44728166

One of the essential parts of Trump's trade policy is reducing the deficit and creating more jobs.[32] Figure 6 shows the impacts of trade war on the American labor market. With the exceptions of the iron and steel industry, unemployment is expected to increase in the coming two years across all sectors. Services, trade and distribution, and the construction sectors will be strongly hit by the trade war.

4.2 How Can China Avoid Import Tariffs Implemented on Chinese Export Goods to the US?

How will China react to Trump's trade war? There are several possible reactions:

- … to impose and increase import tariffs toward goods and services imported from the US. Beijing has retaliated with tariffs on $110 billion of US goods. On August 6, 2019, Chinese companies suspended new US agricultural product purchases.
- … action against US companies that are in close partnership with Chinese firms. This seems to be irrational and not a desirable option. Therefore, it is out of the discussion.
- … to export goods produced in China over third countries to the US. If Chinese export firms want to keep their market size, they can move their production activities to third countries, e.g., neighboring countries, and export goods indirectly from third countries to the US.
- … to devalue/revalue yuan against the US dollar in order to keep the real exchange rate fixed. A weaker yuan makes Chinese exports more competitive and cheaper to

[32] Kimberly Amedeo, "Can Trump Bring Back American Jobs?" https://www.thebalance.com/trump-and-jobs-4114173

buy with foreign currencies. From the Chinese perspective, this strategy is seen as an attempt to offset the impact of higher tariffs imposed by the US administration on Chinese imports into the United States.

- If China would change its development strategy moving from an export- and investment-driven to a domestic- and private consumption-based economy, China would be less dependent on the export of goods and services to the United States.

4.3 How Does US React to Chinese Exports?

There are four possible ways to compete with China's export offensive:

- First, unproductive and inefficient American firms, which are not able to compete with Chinese export goods, will be forced to leave the market. Then, Chinese firms would continue to export from China to the US market.
- Second, US firms operating in the same production line with Chinese firms that do not compete with them can use more capital-intensive technologies (defense-oriented investments) to reduce the cost of production through increasing productivity.
- Third, US companies that cannot compete with cheap Chinese goods must either lower their costs or go out of business. Many businesses reduce their costs by outsourcing their production to China. Outsourcing adds to US unemployment.
- Fourth, the US administration can enforce the protectionist trade policies toward goods and services imported from China without regarding the negative impacts on the American economy.

5. China-US Currency War: Does China Manipulate Its Currency?

In 2018, President Donald Trump accused China of currency manipulation. He continued his accusation in 2019,[33] after the Chinese Central Bank allowed its currency to weaken during the ongoing trade war.[34] The move was seen by the United States as a retaliatory action following Trump's threat to impose a 10% tariff on $300 billion of Chinese goods.[35]

The US government has been complaining about China's currency war[36] since 2006. Most economists believe a higher yuan value against the US dollar will lower the US trade deficit.[37] There is also not only a trade war but also a currency war between the two countries.

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33 https://www.cnbc.com/2019/08/05/trump-accuses-china-of-currency-manipulation-as-yuan-drops-to-new-low.html

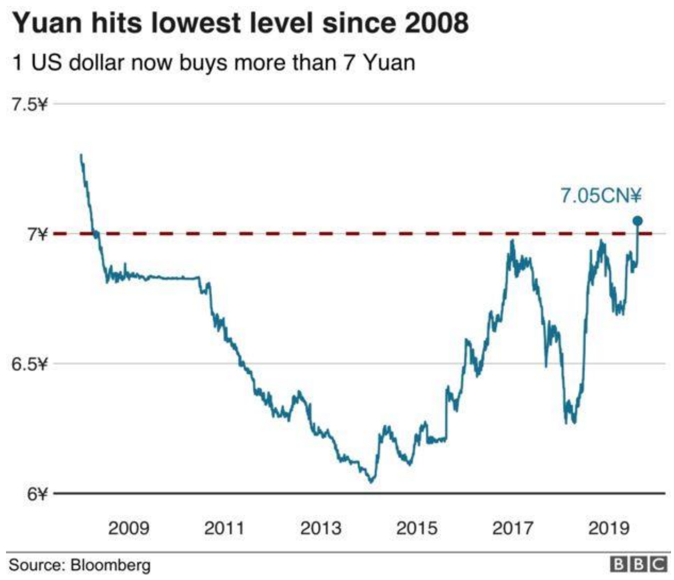
34 Trump's trade war with China is starting to get out of hand, https://edition.cnn.com/2019/08/05/economy/trade-war-china-yuan/index.html

35 https://edition.cnn.com/2019/08/05/business/china-currency-manipulator-donald-trump/index.html

36 https://www.thebalance.com/what-is-a-currency-war-3306262

37 https://www.bbc.com/news/business-45251091

Figure 5: Development of the Yuan against the US Dollar



Source: https://www.bbc.com/news/business-49245654

The Chinese exchange rate system is based on a fixed exchange rate regime. The exchange rate can be defined as the price at which the two currencies can be exchanged with each other. When a country fixes the value of its currency against another currency, it commits itself to maintain the fixed exchange rate, by increasing/decreasing demand for, and supply of its money.

The Bretton Woods System was partly founded on the fixed exchange system in 1944[38] until it broke down in 1971 definitely. Today, there are at least 66 countries that either fluctuate their currency to the dollar or hold the dollar as official reserves. The dollar is convertible and largely accepted and used as a medium of exchange for most international trade and investments transactions.

In the form of the fixed exchange rate system, traders and investors are well-informed of the projection of the exchange rate in the coming years. Then, it is easier for them to make rational decisions on business initiatives. The exchange rate would not be in uncertain, rapid, and unexpected fluctuation in the foreign exchange market. The proper functioning of the fixed exchange system mainly depends on the central bank's sufficient foreign exchange reserves. If the central bank has enough reserves, that country's central bank can intervene in the foreign exchange market during exchange rate fluctuations by selling or buying enough dollars to bring its currency back to the long-term fixed exchange rate path.

The value of the dollar is determined in the frame of the flexible (free floating) exchange rate regime. This means that the value of the dollar is set up according to the demand for dollars and supply of dollars. If the dollar's value fluctuates, then central banks of fixed exchange

[38] ttps://www.thebalance.com/bretton-woods-system-and-1944-agreement-3306133

rate regimes must intervene to keep up the value of their currencies fixed against the US dollar.

5.1 The Relationship between the Dollar and the Yuan: How Does China Manage the Yuan's Value?

China has accepted the fixed exchange regime, and the yuan is fixed to the US dollar. The yuan is pegged to the US dollar for two reasons. First, the dollar is used as a medium of exchange in international transactions and is accepted as the worldwide reserve currency. Second, the United States is China’s biggest trading partner. One of the main conditions for keeping its competitiveness in the American market is that China must control its export prices through maintaining the fixed exchange rate. This depends on the maintenance of the real exchange rate, which indicates a country’s competitiveness in the international market through devaluing or re-valuing its nominal exchange rate against the US dollar.

China pegged the yuan’s value at a two-percent (up and down) trading borders around an “intervention rate” that determines the dollar's value. China's central bank is called the People's Bank of China, which is managed and controlled by the Communist Party.

The People's Bank of China decides each day what the foreign exchange rate for the yuan will be and manages it throughout the day. For the last 11 years, until August 2019, China has kept its currency below a symbolic 7-to-1 ratio to the dollar. (See Figure 5)

5.2 How Does China’s Fixed Exchange System Operate

China's exporters receive dollars when they export goods to the United States. They deposit export revenues into their local banks in China, which transfer it to the central bank in exchange for yuan. They use yuan to pay their workers and local suppliers.[39] The People's Bank of China holds dollars in its official foreign reserves. By accumulating dollars, the People's Bank reduces the supply of dollars available for trade. It puts upward pressure on the dollar's value, lowering the yuan's value.[40] When the bank wants to increase the yuan's value relative to the dollar, it will use its dollar reserves to buy yuan from Chinese banks. By taking yuan out of circulation, the bank increases the yuan's value. By replacing yuan with dollars, it puts more dollars into circulation and lowers its value. The central bank buys US Treasury stock.[41]

China is the largest foreign holder of the US Treasury.[42] China buys US debt to support the value of the dollar. This is because China pegs its currency, the yuan, to the U.S. Dollar. It

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[39] Kimberly Amedeo, “How China Influences the U.S. Dollar”, https://www.thebalance.com/how-does-china-influence-the-u-s-dollar-3970466.and The Guardian https://www.theguardian.com/business/2015/aug/11/china-devalues-yuan-against-us-dollar-explainer

[40] Ibid.

[41] Treasury bills, notes, and bonds are also called "Treasurys" or "Treasury bonds" for short.

[42] China has the greatest amount of U.S. debt held by a foreign country. Japan comes second at $1.10 trillion. It's followed the United Kingdom at $332 billion, Brazil at $306 and Ireland at $271 billion. See Kimberly Amedeo, https://www.thebalance.com/u-s-debt-to-china-how-much-does-it-own-3306355.

devalues the currency when needed to keep its export prices competitive and fixed.[43] China makes sure the yuan is always low relative to the U.S. dollar. But China's ownership of the U.S. debt is shifting the economic balance of power in its favor.

Why? Part of China's economic strategy is to keep its export prices competitive. If the dollar began strengthening, China would allow the yuan to weaken to the dollar in order to remain competitive in the international markets. A weaker currency is making China's goods cheaper for American consumers, which could offset some of the negative impacts the tariffs.[44]

This question has been asked by investors and economists: What would happen, if China partly sold the treasury's (bonds/bills) it currently holds; what if it sold all of them? The value of the dollar would drop rapidly and this would initiate a chain reaction throughout the stock exchange market. The other possibility in question is if China were to decide to reduce buying new US treasuries in order to close the budget deficit. This would have catastrophic consequences. Both of these options would damage not only the US economy, but also the Chinese one. Simply, China would lose its biggest trading partner.[45] Therefore, the implementation of these two political options seems to be out of the question.

6. Conclusion

6.1 Who Is the Loser and Who Is the Winner?

"… Western politicians must understand that the economic, scientific and technological rise of China is unstoppable, and come to terms with this as a fact of life. The only way to race against China is to compete with it." [46]

- Helmut Schmidt, Former Chancellor of Germany

A new study conducted by the Rhodium Group, which is commissioned by the US Chamber of Commerce, finds that tariffs significantly reduce US gross domestic product (GDP), employment, and investment, while export and import prices will rise, making US products less competitive overseas and consumer products more expensive for American shoppers.[47]

The trade conflict between the United States and China has not yet affected trade flows, which are still growing in favor of China. Despite the Trump administration's penalty tariffs

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43 Kimberly Amedeo, "US Dollar Value Measured Three Different Ways" https://www.thebalance.com/value-of-us-dollar-3306268.

44 The United States allowed China to become one of its biggest bankers because Americans enjoy low consumer prices. Selling debt to China close US budget deficit and financing for government spending that induces U.S. economic growth. It also keeps U.S. intertest rates low

45 Bryan Borzykowski, "China's $1.2 trillion weapon that could be used in a trade war with the US," https://www.cnbc.com/2018/04/05/chinas-1-point-2-trillion-weapon-that-could-be-used-in-a-us-trade-war.html.

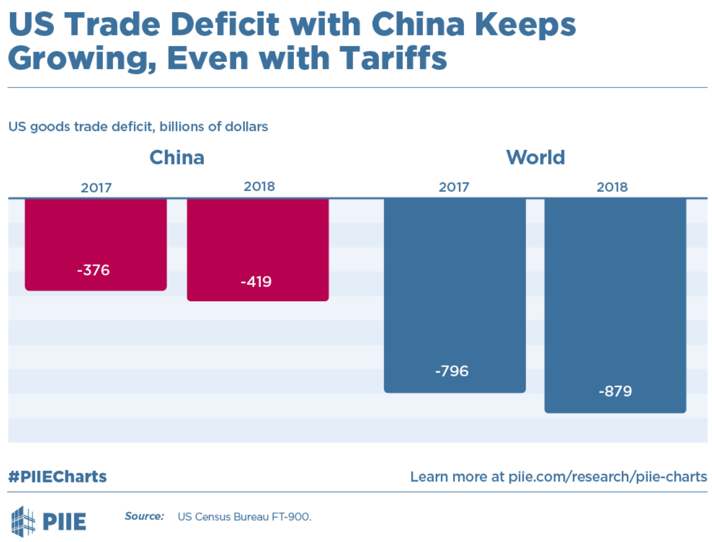
46 Helmut Schmidt, Vertiefungen (Deepening) (Berlin: Siedler Verlag, 2010), 303–305.

47 Finnbar Bermingham, US-China trade war could slash US$1 trillion from US economy in a decade warns Chamber of Commerce, 19 March 2019 https://www.scmp.com/economy/china-economy/article/3002376/us-china-trade-war-could-slash-us1-trillion-us-economy-decade

on China, the US trade deficit in goods with the country could not be reduced at all. Obviously, the initial round of tariffs imposed by the United States has not stopped Chinese firms from exporting more goods to the United States in the last year.

Figure 6 exhibits the US goods trade deficit with China, which was $419.2 billion in 2018, an 11.6% increase ($43.6 billion) over 2017. The United States had a services trade surplus of an estimated $41 billion with China in 2018, up 0.8% from 2017. The United States imported $539.5 billion worth of goods from China in 2018, compared with $505.5 billion in 2017. U.S. goods exports to China totaled $120.3 billion last year, dropping from nearly $130 billion in 2017.[48]

Figure 6



Source: https://www.piie.com/research/piie-charts/us-trade-deficit-china-keeps-growing-even-tariffs

Figure 6 also clearly shows the full extent of the US foreign trade deficit in goods. The US not only has a trade deficit with China but also a large deficit with many other trading partners, among them France, Germany, Italy, Canada, Mexico, Japan, and South Korea.

As long as demand for imported goods and services in the United States continues, the United States will continue importing them from other countries.

6.1 What Is the Most Important Economic Problem in the United States?

As former chairman of the Council of Economic Advisors and Harvard Professor Martin Feldstein has written, "every student of economics knows or should know that the current ac-

48 US Census. https://www.census.gov/foreign-trade/balance/c5700.html

count balance of each country is due to excessive government budget deficits and households consuming beyond their means."[49]

As many experts have noted, the US trade deficit is largely determined by its low national savings ratio arising from its huge federal budget deficits. In other words, the American economy is largely based on high household spending. In plain language, the economies outside the US have been financing the US's current account deficit, consumers, and public spending. US gross savings was 19 percent in 2017.[50] In May 2019, the personal savings rate in the United States amounted to 6.1 of GDP percent.[51]

Stiglitz argues that the United States has been running trade deficits mainly because Americans save too small a share of their income. According to this logic, if Washington wants to reduce its deficits, it must implement policies that force greater US savings:

> "*…The US has a problem, but it's not with China. It's at home: America has been saving too little. Trump, like so many of his compatriots, is immensely short-sighted. If he had a whit of understanding of economics and a long-term vision, he would have done what he could to increase national savings. That would have reduced the multilateral trade deficit…"*[52]

On the other side, China's national savings rate is indeed impressive (47% of GDP).[53] By definition of balance of payments, the foreign trade deficit equals capital inflows in terms of FDI or portfolio investments and a decrease in official reserves held by the Central Bank, which is also equal to the difference between domestic investments. When fiscal deficit goes up and domestic savings go down, the trade deficit goes up.

If the United States' domestic investment continues to exceed its savings, it will have to import capital and have a large trade deficit. Worse, because of the tax cuts enacted at the end of last year, the US fiscal deficit is reaching new records—recently projected to exceed $1 trillion by 2020—which means that the trade deficit almost surely will increase, whatever the outcome of the trade war.[54]

Rather than focusing on trade restrictions, America's interest should be on strengthening the productivity of its labor force through infrastructure investments and using more capital-intensive technologies. The other possibility is closing these inefficient companies or replacing them in other countries. But this appears to contradict the "America First Policy."

China has been heavily criticized not only by the US administration under Trump but also to some extent by the EU, mainly Germany, concerning its investment and trade policies. The

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[49] Yukon Huang, "What the West Gets Wrong about Chinese Economy", Foreign Affairs, September 14, 2017. https://carnegieendowment.org/2017/09/14/what-west-gets-wrong-about-china-s-economy-pub-73109.

[50] https://data.worldbank.org/indicator/NY.GNS.ICTR.ZS

[51] Personal saving rate is calculated as the ratio of personal saving to disposable personal income https://www.statista.com/statistics/246268/personal-savings-rate-in-the-united-states-by-month/

[52] Michael Pettis, "The U.S. Trade Deficit Isn't Caused by Low American Savings", Carnegie Endowment, August 08, 2018, https://carnegieendowment.org/chinafinancialmarkets/77009.

[53] Word Bank data, https://data.worldbank.org/indicator/NY.GDS.TOTL.ZS?locations=CN

[54] Joseph E. Stiglitz – July 30, 2018 The US Is At Risk of Losing a Trade War with China, Project Syndicate,

https://cgt.columbia.edu/news/stiglitz-us-risk-losing-trade-war complaints can be summed up as follows: "the alleged violation of private intellectual property rights, the forced technology transfer from foreign to Chinese enterprises through its joint venture requirements, massive subsidies suspecting the legitimacy of anti-dumping procedures, unfair import tariffs, and complaint of undervaluing the national currency against the US dollar."[55]

By July 1, 2018, China started to reduce import tariffs on a Most-Favored Nation base (MFN) against all trading partners. For almost 1,500 items, mostly consumer goods, tariffs were cut by almost 60 percent from an average level of 15.5 percent to 6.9 percent. Even today, Chinese tariffs are still significantly higher than those of the EU, Japan, and the US.[56]

All these measures would not satisfy its counter partners, the US and the EU. In the short term, China must accept the rules of the game set up by international agreements regulating international trade. And it must be fully ready to open up its economy to international competition. On the other side, China should not only be criticized by its trade partners through trade restrictions and trade war, but it must also be included in the global regulatory framework. A general "containment" of China or "de-coupling" should absolutely not be accepted as an option.[57]

The *Economist* suggested that "…The strategy of the American government should leave room for China to rise peacefully- which inevitably also means allowing China to extend its influence… America and China need to co-operate despite their rivalry… The two countries should be more commercially intertwined."[58]

The IMF has rightly recommended to Chinese policy makers that China, "as one of the main beneficiaries of the global trading system, has a strategic interest in playing a leading role in defending it. Doing so also means accelerating China's opening, maintaining progress in reducing the current account surplus, and continuing to seek to resolve trade disputes through established mechanisms (e.g., the World Trade Organization dispute settlement) or negotiation."[59]

The basic question now is: When and how can the trade war end? If any economy starts to weaken, policy makers generally put the blame on outsiders such as Trump is doing now (e.g., on migrants, China) and follow "populist policies."[60]

[55] 01901_Policy_Paper_BDI_China.pdf.p.3

[56] Rolf L Langhammer and Wan-Hsin Liu pointed in the paper "China between External Pressure and Domestic Policy Reforms: In Search of Balance :3.2. Weaknesses in China's Tariff Policy. See Kiel Policy Brief. No 117.August 2018. pp.10-12.

[57] BDI Report on China, January 2019, p.2

[58] The Economist also pointed out that" ... Alliances with the EU, Japan and Australia, India and Vietnam are best source of protection against the advantages China will reap from its economic and military power", "China v. America", October 20th-26th 2018, p.13.

[59] IMF, Peoples Republic of China, Staff Report IMF Country Report No. 18/240, June 28 2018, pp. 23-24.

[60] EEAG (2017), *The EEAG Report on the European Economy*, "Economic Policy and the Rise of Populism – It's Not So Simple," CESifo, Munich 2017, pp. 50–66. https://www.ifo.de/DocDL/eeag-2017-economic-policy-and-the-rise-of-populism.pdf.

For the time being nobody can make any predictions on the outcome of the trade war. It seems nobody can easily win this war, and it will be costly. The continuation of the trade war between China and the United States will more or less cause strong economic turbulence in every nation as long as both Trump and Xi hold on tight to their trade policy and they do not behave as responsible statesmen.[61]

In a new research paper published by the Institute of World Economy, Kiel, on the topic of "The Impact of the US – China Trade" investigates the potential indirect effects of tariff hikes in the recent US-China trade war on other trading partners. Researchers Haiou Mao and Holger Görg argue, "…because of close trading relationships, the US, the EU, Canada and Mexico are hit hardest in absolute terms by increased US tariffs on Chinese imports. We estimate that the tariffs impose an additional burden of between 500 million to 1 billion US dollars on these two countries. The EU is also heavily affected. China's tariffs on US imports have less of an effect. This shows that third countries are not unaffected by trade."[62]

As a final statement, to borrow words from Paul Krugman, "at this rate, we may have to wait for a new president to clean up this mess, if she can…"[63]

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[61] Laurence Boone, OECD Chief Economist, stated that trade tensions have disrupted growth. With uncertainty high and confidence low, investment has suffered, and the manufacturing sector has taken a hit OECD Economic Outlook 2019, https://www.oecd.org/economy/economic-outlook/

[62] Haiou Mao and Holger Görg, Friends like this: "The Impact of the US – China Trade War on Global Value Chains", No. 17 | August 2019, KCG Working Paper, KCG Working Paper No. 17 | August 2019, p.15.

[63] Paul Krugman, "Trump's China Shock", Aug.5.2019, https://www.nytimes.com/2019/08/05/opinion/trumps-china-shock.html.