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Title : Trade & Conflict: US & China Trade Agreements

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Abstract

The US and China are the two key global superpowers dominating the world today. The relationship between these two nations has, and will continue to shape the outcome of the world we live in. This paper will investigate both trade and financial agreements between the US and China, first by looking briefly at a history of the two nations to distinguish precedent from legacy. It will also examine the different types of labor each economy employs, how it is used and question the net effect of these differences in the economic and political spheres. Last we will examine the issue of trade imbalances, GDP computation, currencies, and the implication they holds for the future. The period from 2000 to the present day will be addressed separately; as we have entered an economic era where the “new normal” has yet to clearly establish itself.

Keyword : trade and financial agreements 、 trade imbalances



Table of Content

Topic	Page
<u>Historical Overview</u>	3
<u>Trade Policy</u>	5
Soybean Trade	5
Solar Power.....	7
Tires	11
<u>Employment and labor</u>	11
<u>Monetary & Fiscal Policy</u>	13
The RMB Peg	13
The Problem with Numbers.....	15
GDP, GNP & Other Exciting Acronyms.....	16
<u>Conclusion</u>	20
<u>References</u>	27
<u>Appendix</u>	32
Part A	32
Part B	34



A Historical Overview

The political and economic histories shared by a pair of trading nations greatly influence the present feelings of warmth or animosity toward one another. Furthermore, legacy agreements sometimes have a tendency to undermine what would otherwise be potentially sound trade, or policy arrangements. Briefly examining the

US and China's 250 year trade history we will uncover some interesting facts and quirks of behavior that still influence each nations public opinions (and therefore governmental policies) today.

In the early days of Chinese/US trade most business consisted of a flow of capital and monetary payment from the US to China in exchange for finished products such as laquerware, porcelain, furniture and a limited range of raw materials such as tea and cotton. The middlemen (merchants) who were operating in the period before mercantilism became very wealthy. The Chinese producers recognized the demand for finished products and the higher price they could command and output was adjusted accordingly.

Because of colonial and European imperialism China was still understandably apprehensive about opening to trade with foreign powers. It was not until the end of the First Opium War and the Treaty of Nanking when China was forced to open certain ports for trade and business really began to flow. One of the first Sino-US trade agreements signed by President John Tyler in 1844 (the treaty of Wangxia) allowed not only extraterritoriality, but trading rights on an equal level to those of the European powers. Even after this time Beijing remained closed off to foreign influence and it was not until the end of the Second Opium War (1860) that China's capital city would become accessible to foreign investment and trade. At this point it is worth noting that from very early on we are already referring to "foreign influence", and "colonial/European imperialism". From a Chinese standpoint, even with extensive knowledge of the outside world, the general attitude of the populace was that of a person being "Chinese or Foreign", with little distinction of other nations except in academic circles. The Western powers habit of warmongering left a considerably negative impression of outsiders on the Chinese populace.

One notable exception to the Chinese indistinction of foreigners was the emigration of Chinese labor to California between 1844 - 1855 for the California Gold Rush. This exodus of labor was also pivotal in providing a large enough workforce to create the Transcontinental Railroad; a feat of engineering that was a huge influence on US commerce and economy at the time. This influx of labor spurred anti-foreign sentiment from US laborers who believed that Chinese immigrants were taking their jobs and working for below average wage, thus depressing the wage level of the average US working man. (There is evidence to both support and refute this.) Foreign immigration and fear of job loss is again a recurrent theme in the US, though now more notably in connection with Mexico and other South American countries. With China's recent development of newer and more technical industries, the idea that "the Chinese are taking our jobs" is again making a resurgence in US thought as evidenced by mainstream media outlets. In 1882 the US introduced its first restriction on immigration, the Chinese Exclusion Act which stood in one form or another for 60 years.

After the Second World War China split into two factions, the PRC and ROC. Prevailing US foreign policy at that time was strongly anti-communist and so the US elected to recognize only the ROC (hereafter referred to as Taiwan) as the true Chinese government. The US strove (not always successfully) to prevent the PRC's (hereafter referred to as China) entry into international bodies such as the United Nations (25 Oct 1971, the earlier joining in 1945 was for the ROC and then rescinded)^[1], WTO (17 Sep 2001), IMF (27 Dec 1945) and BIS (11 Mar 2011). They also placed numerous trade embargoes and encouraged their allies to take a similar political position, only tentatively opening trade with them (under President Nixon) in 1972/73. It was not until even later (January 1, 1979) that the US reversed its position (the Joint Communiqué on the Establishment of Diplomatic Relations) and formally transferred diplomatic relations from Taipei to Beijing.

In 1989 after violent Chinese suppression of a peaceful democratic demonstration in Tiananmen Square the US government came under political pressure from its populace to condemn the Chinese actions. This time there was a suspension of political exchange and weapon sales, combined with further economic sanctions^{[2][3]}. For a more concise listing of the above events and more, please see Appendix Part A which is a trade/political economic history timeline showing the relationship between the US and China.

So in the present day what products, materials and exchanges currently take place between the US and China?

Trade Policy

“No nation was ever ruined by trade.”

Benjamin Franklin

Soy Bean Trade

Soybean oil is a pivotal oil to the Chinese^[4] and a key export of the US agricultural industry. In the US the agricultural industry is fiercely protected by tariffs, incentives and subsidies (much like the automotive industry amongst others). In China more than two-thirds of cooking oil comes from soybeans, in 2012 more than half of US soy exports were to China, and the US was China's biggest supplier^{[5][6]}. In the US the price of food has remained relatively flat according to official CPI data (this is itself questionable); however the price of soybeans per bushel is continually breaking new highs, even surpassing the previous high during the 2007-08 food crisis^[4]. What is the reason for the dramatic surge in prices?

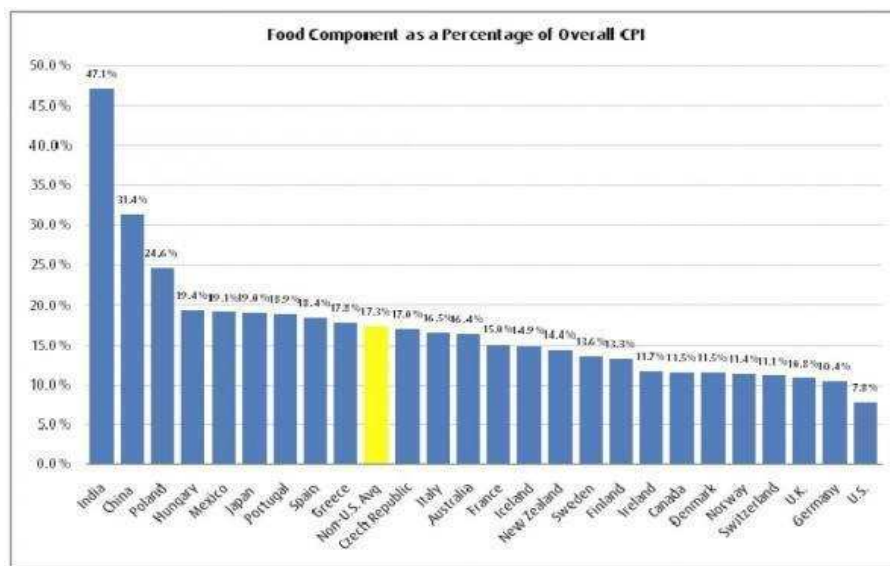
“The surge in prices is because of falling global production levels following dry weather in Latin America and increased China imports. Soy’s wide range of use as feed for cows, sheep, pigs and poultry – and as a source for oil used in foodstuffs such as biscuits and cakes – means its high price could trigger food inflation fears.”

“Soybean production is sharply down in the agricultural belt of Brazil, Argentina, Uruguay and Paraguay as the La Niña weather phenomenon has exposed fields to hot, dry weather over the past few months. Latin America accounts for about 55 per cent of global exports of the commodity.

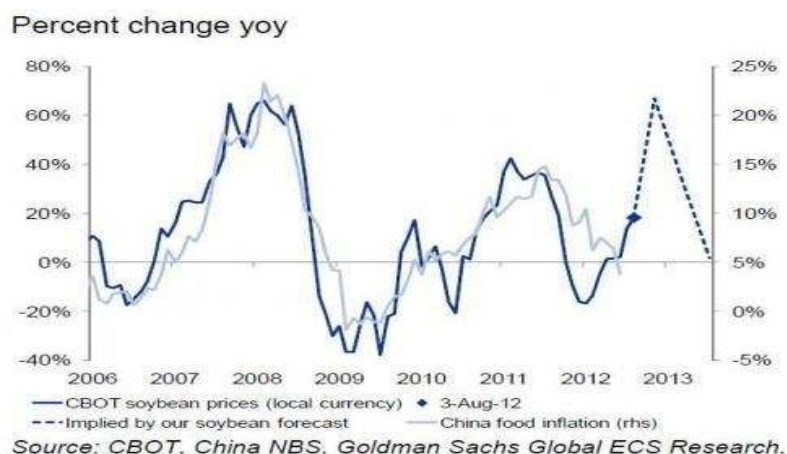
The US Department of Agriculture estimates that global soybean production in the 2011-12 growing season will suffer its biggest annual drop in absolute terms since records began in 1965.”

Financial Times (April 29, 2012)^[7]

When we break down the CPI basket for individual nations we can see the difference in weight given to food. Below is the food price as a component in China, where it is above 30% of the entire CPI; and the US, where it is the world’s lowest at less than 8%.



The PBOC is highly sensitive to food prices because the population of 1.3 billion devotes more than 20% of its income to food (three times more than Americans - according to the USDA). Any dramatic rise not just in grain prices, but also in the upstream prices of meat, eggs, and milk (where there will undoubtedly be a knock-on effect) could even be regime changing. Authorities will likely be concerned with the prices because of their effect on social stability/contentment; as IHS points out “Inflation has a long history of sparking discontent, so obviously it's on the forefront of the Chinese leadership's mind.”^[8] Examining the following chart we can see a remarkable correlation between CBOT soybean prices and Chinese food inflation.



Interestingly Alistair Thornton another IHS economist in Beijing counters “There is little pressure from inflation to move on monetary policy... There is room, nonetheless, for a reserve requirement ratio (RRR) cut over the next few months, given potential tightness in the banking system.”^[9] He goes on to state that 2.6% inflation (in 2013) is still well within the government’s 4% limit. However Mr. Thornton’s comment seems somewhat self-contradictory in that it suggests there is no need for concern, and at the same time (indirectly) stating that PBOC needs to reduce the RRR to increase the money supply. Perhaps the PBOC CPI basket of goods is hugely understating inflation as it is in the US^[10]. We believe that Soy prices will soon become a major thorn in the side of the PRC as inflation ramps up.

Solar Power

“The use of solar energy has not been opened up because the oil industry does not own the sun.”

Ralph Nader

Peter Voser, the CEO of Shell (Royal Dutch Shell (NYSE: RDS.A)) recently explained that in the future it is likely governments will take one of two different approaches to alternative energies, the first involves high levels of government intervention, the other involves free markets. Shell believes that with high government involvement natural gas will grow to become the number one global energy source. The second outcome is where the market is allowed to progress naturally, which they believe would result in higher fossil fuel demand (especially coal) leading to higher oil prices. They go on to state that the resulting higher

energy prices would encourage investment in research of alternative sources of energy; the net effect of which would be to cause solar power to become the main source of energy on the planet in about 50 years time.^[11]

It seems that both the US and China have chosen the second path, yet impatiently “stimulate” their own fledgling solar industries in an attempt to circumvent the use of the free market. This is not entirely contrary to what Mr. Voser outlined, but it seems he underestimated quite how interested governments are when it comes to being the key power supplier for the 21st century. Each nation is presently locked in a race to produce the most efficient solar panels, but with the help of huge government subsidy. Both the US and PRC are pre-empting the future demand for an efficient and renewable energy source by using government funds to leapfrog the demand need and move directly to a more efficient finished product.^[12] This could be construed as far reaching vision from both governments, however in April 2012 the “Solar Trust of America”

(STA) filed for bankruptcy; despite the fact that in April 2011 STA had received a \$2.1 billion conditional loan from the Department of Energy (the second largest ever issued by the Department of Energy). That investment was intended to fund expansion in the 1,000 MW Riverside California Plant creating around 8,500 jobs in the area.^[13] STA is not alone, in 2011 NextEra Resources received \$935 million. Again, LSP Energy, Ener1 Inc. and Energy Conversion Devices Inc. have all gone bankrupt after receiving government funding. In the US it seems that the government intervention so far in such ambitious projects has failed to produce the desired effect.^[14]

However there are greater implications to this than just mis-allocation of government funds (gross as this is in itself). Associated Press reports^[15] that “China Declares US Energy Projects Violate Free Trade Rules”.

Previously both China and the US had pledged to cooperate on developing new energy technologies:

“The Chinese probe was launched last November (2011) two weeks after Washington said it would investigate whether Beijing is inappropriately subsidizing its own makers of solar panels, allowing them to flood the U.S. market with low-priced products and hurt

American competitors.”

With both China and the US pointing the finger it is easy to miss the way all of these projects are being funded and what effect that has. China (who presently has the highest corporate debt level in the world^[16]) is also subsidizing SunTech Power Holdings. Reuters reports^[17]:

“Banks in Wuxi, Jiangsu province, have extended new loans totalling 200 million yuan (\$31.73 million) to locally headquartered solar power giant Suntech Power Holdings Co Ltd, the Shanghai government-owned China Business News reported on Friday, citing anonymous sources. Suntech, the world's largest maker of solar panels, whose shares hit a high of \$90 in early 2008, runs the risk of being removed from the New York Stock Exchange for failing to keep the average closing price of its shares higher than \$1 over the last 30 trading days as of Sept. 10, Suntech said in a statement on September 21. Shares in Suntech, like rivals JA Solar Holdings Co , Trina Solar Ltd and Yingli Green Energy Holding Co, have fallen sharply in the past three years as sales prices have tumbled, squeezed by declining demand in export markets and overcapacity at home.”

Even in January companies like ChaoRi Solar Power (non-state owned) are still precariously close to default. Again from Reuters^[18]:

“A Chinese solar firm which nearly produced the country's first domestic bond default will complete an interest payment on schedule after a local government intervened on its behalf. Investors say the latest instance of a government riding to the rescue of a troubled Chinese firm has led to moral hazard and inefficient credit allocation.”

At the time of writing in recent news^[19] we see that SunTech has finally defaulted on payment of notes due to the tune of \$541 million USD. This default sent the stock price crashing and will almost certainly have them struck off the NYSE, further inhibiting any recourse to funding.

“China has supported solar companies through credit lines from local government or state-backed agencies. Solar companies, Suntech, LDK, Trina Solar Ltd (TSL), Yingli Green Energy Holding (YGE) Co., Hanwha SolarOne Co. and Jinko Solar

Holding Co. were among 12 companies that obtained more than \$43.2 billion in credit pledges from China Development Bank Corp., according to data compiled by Bloomberg. LDK [the second largest solar wafer maker], which received a bailout in July for part of its debt from the local authority in Xinyu, said on Jan. 31 that it received approval for a 440 million yuan (\$71 million) loan from China Development Bank. Suntech has been talking with the government of Wuxi about the possibility of financial support. LDK has reported six successive quarters of losses through the third quarter of 2012. Its net debt totaled almost \$3.3 billion, according to data compiled by Bloomberg. It’s due to give full-year earnings on April 15.”

Why the Chinese local government turned around on its former “zero default” policy (this is the first “allowed” bond default from a publicly listed Chinese company) and the effects of this on the market generally still remain to be seen. It is also unclear if this was a bout of sound economic policy in allowing a default to ensure more appropriate allocation of capital and resources, or whether the local government was spent out and unable to request further funds from Beijing who was under pressure from the US. Either way China has taken the plunge into default and this may leave the way for fresh competition for the US from South Korea. We do think however that this is unlikely to cause any abatement of Chinese government funding mis-allocations.

At first glance it appears solar power companies are competing at the global level, but when we look more closely it seems that it is the governments behind them that are providing the funding for growth and development, especially in this era of increasingly tired looking economic forecasts.

Tires

Back in 2009 we saw the news that the Obama administration was under pressure from Labor Organizations to impose tariffs on tire imports from China. The US imposed the requested tariff which was the first of its kind (labelled a “safeguard” provision). On top of the existing 4% tariff, in the first year there was a 35% charge, followed by 30% in the second year and 25% the year after that^[20]. US sales of Chinese tires had almost tripled between 2004 and 2010, rising to some 46 million units. The United Steelworker Union had originally requested 55%, 45% and then 35% increases for years 1 - 3, however China claims that even the present tariff hike is contrary to WTO free trade agreements. Later in 2012 there was again pressure from the US to begin imposing duties on all imported Chinese auto-parts, this was when the US was running a \$10 billion USD deficit against products of the same type^[20].

Since imposing the restrictive taxes on Chinese imports US tire production still has yet to see an upturn, instead in 2011 there was a three-fold increase in imports from Mexico, formerly one of the US’s biggest suppliers (after Canada and South Korea). With new Pirelli plants in Mexico coming online in 2012 we can expect to see more trade from Mexico who is trying hard to compete with Chinese labor costs.

But with China *potentially* heading for a trade deficit (globally, not with the US) these restrictions and duties may be perceived as an extreme punishment that the US is doling out. Fitch Ratings observes^[21] that in 2007 for every dollar of credit China was getting a \$0.77 return, however by 2011 that return had dropped to \$0.44. With crashing house prices (Beijing down 35% and coastal areas near Shanghai down 25%) there is a need to maintain growth in the economy at home, and China quite simply does not have the internal consumption to support their production. Despite the widespread collateral base from the BRICS countries that they have worked hard to establish (or buy their way into with currency swaps) these countries *also* still have their own infrastructure problems. The issues and questions surrounding computation of China’s import, export and GDP statistics is covered later in this paper.

Employment & Labor:

Looking at the types of product each nation offers for trade we can see that high technology,

skilled workmanship is still vastly more prevalent in the US. China clearly desires a more skilled workforce and greater access to foreign production techniques as this will raise the end value of finished products. However this access can only be obtained by working in partnership with foreign firms, gaining the experience of working with them.

Much of China's labor force is still low or unskilled labor and as useful construction projects at home dry up due to the lack of support from the economy China is expanding globally by moving into Africa and South America. This does assist in strengthening the economy (real collateral and real assets increase real wealth) however in terms of value added to the workforce it does very little. Arguing for China's continued growth

(measured however you like, whether GDP, TFP, PPP etc.) necessarily involves development of the workforce as volume of labor is China's primary driving power. Even though the percentage of Chinese in the active participation labor force category dropped in 2011^[22] (due to the effect of the one child policy and some statistical re-jigging) we can still expect China to rely solidly on its sheer numbers to succeed in the near future (15-20 years). However the PRC policy makers are aware of this drop off in population and are scrambling to develop the existing labor force to compensate. More value for less work makes sense wherever you are in the world, especially when you still have an export based economy.

The US labor force is not without its own problems however. Despite the high literacy rate^[23], with economic stimulus packages at home encouraging high private debt and government mis-spending the

“animal spirits” of the economy remain skeptical of any kind of recovery since 2008. For many people work is still hard to come by Graham Summers of Phoenix Capital Management in May 2013 comments:

“In the US, last week's jobs report didn't look too bad until you dug deeper into the report and found that the average workweek declined by 0.2 hours from March- April.

So what you may ask... 0.2 hours? Just under a 15 minutes per week?

The issue here is that if you apply this drop to the total number of people employed in the private sector, this is the equivalent of

over 21 million work hours being lost in one month. That is the single biggest drop since April of 2009 when the US economy was absolutely imploding. It's the numerical equivalent of firing 718,000+ people."

If examining the greater implications of this seemingly innocuous change there is evidence of a labor force on the slide. It looks like the US is becoming increasingly unable to employ its own people in productive industry (ignoring all government subsidized production) and rather than immediately lay them off, industry is clinging tooth-and-nail to retain staff and some degree of productivity.

Monetary and Fiscal Policy

The RMB Peg

"The International Monetary Fund's rules are very clear. They say, 'Thou shall not competitively undervalue.' With any prolonged, one-way, massive intervention, you are violating the IMF rules of the game."

C. Fred Bergsten, Director of the Peterson Institute for International Economics.

The popular story circulating in current press with regard to the RMB is that its undervaluation results in China having an unfair advantage in production, thus producing a trade deficit for its partners and loss of employment (especially in the US). However as with almost all the cases investigated so far, the real story is much more complex. Almost all growth in China stems from Nixon's agreement to trade in the 1970's. At this time China was able to produce simple electronic goods, toys and clothes very cheaply, however the general populace was still so poor that there was no home market available for them. The growth generated in China by the agreement between the US consumer and PRC inevitably led to a fear of the opposite, recession. Unhappiness during a heavy recession could be regime changing, something very costly for a socialist government.

The PRC intolerance of recession now means that the PRC is trapped by its own successes (of

trade surplus) and this fact agrees strongly with the common reports we hear from China since 2011 regarding fixed books, exaggerated growth figures and GDP. Even with all the USD reserves that the PRC has accumulated, selling these on the open market (whilst initially bad for the USD value and inflation in the US) may be devastating in terms of a RMB revaluation. The official line from the PRC is that the RMB value is a purely domestic issue and that they will manage their business responsibly, Chinese press reports often express amazement at Washington's obsession with the RMB valuation (or mis-valuation) process.

Despite the PRC official line that RMB value is a domestic issue, in recent years we have seen some moves to tentatively allow floatation. Until 2005 the RMB was pegged to the USD. China then began to allow a small margin of float attached to a basket of currencies selected by the government, this change resulted in a 22% appreciation for the RMB^[16].

We feel that these allowances are the PRC's first tentative movements toward a free floating exchange rate (think "testing the water before you get in"), however the policy changed again in 2008 (post-crisis) and again in 2010 when the RMB was (unofficially) re-pegged and then un-pegged from the USD. It appears that the PRC are undertaking some serious experimentation with their fiscal and monetary policies. Further reasons for the change in policy may be the requirement to comply with WTO and IMF Articles on the General Agreement on Tariffs & Trade.

There are many reasons why the PRC would wish to hold down its exchange rate, one key issue is inflation^[24]. As discussed above inflation is dangerous. If the PBOC seek to hold their currency artificially low then they must accordingly stockpile enough foreign currencies (through trade) to prevent the subsequent inflation. This measure however can only go on so long as trade is continuing in their favor. Economists generally agree that the RMB is undervalued, the main point of contention comes when discussing by how much. Wikipedia quotes some better known economists (all Keynesian however) and organizations such as IMF, WTO who quote figures ranging from 5% to 27% undervaluation. Such a wide disparity must of course be questioned and resolved.

US economists are concerned by the effect of undervaluation, not only on labor, but also on

Chinese consumption of imports. We have already referred to the poor home market for Chinese made goods, the situation however, is considerably more dire for goods of foreign origin. The lack of RMB purchasing power makes any foreign items a relative luxury. Another effect is the artificially suppressed price of assets which international investors now have access to. This FDI opportunity seems to be a golden goose that just keeps laying, however with no allowed appreciation of the RMB the inflation pressure continues its inexorable march upward for the PBOC.

As discussed above the connection between capital allocation and exchange rate, via the necessary accumulation of international reserves will eventually place pressure on banks affecting their lending behavior. Under-performing loans, mis-allocation of capital and mis-represented statistics are all well known to be a staple of current Chinese accounting and economics. Despite re-capitalization of its major banks (\$800 billion USD since 2003) the PRC is still struggling with the burden of inefficiency. Merrill Lynch in July 2010 estimated that of the \$1.1 trillion lent by banks to local Chinese Governments, 23% were “clearly rotten” and not “financially viable” loans.^[25]

The Problem with Numbers

“73% of all statistics are made up on the spot.”

Unknown

As we can see from the tables in Appendix Part B reported by the US China Business Council, the United States is currently the largest importer of Chinese products, importing a total of \$382.3 billion in 2010, a 29.2% increase over 2009. From the tables, we can also see that most of the products China imports involve advanced manufacturing techniques, things the Chinese are presently unable to easily replicate, such as electrical machinery, power generation equipment and certain vehicles. A majority of imports from China consist of light industrial manufactured products, such as toys, footwear, clothing, and furniture; this represents 26.1% of total imports.

On paper it all looks quite ugly for the US (if you believe a deficit is a bad thing). The US deficit with China in 2011 appears to be somewhere in the region of \$295.5 billion; and making the most base comparison of net figures we can see that in 2010 and 2011, the United States was importing to 3 times more goods from China than it was exporting to them (in USD value terms). Looking at the historical tables we can see that this imbalance is consistent and grows year on year; despite the PRC grumbling about the price of the USD and how it is devaluing. But is it really as bad as the numbers make it appear at first glance?

GDP, GNP & other exciting acronyms...

“If GDP is telling us that the US economy is steadily improving, how come so many folks on Main Street feel so bad? Don't they read the papers?”

Don't they know the GDP is improving?”

Joel Bowman - The Daily Reckoning

The US and PRC are the two largest national economies, and the gravity model suggests that they should enjoy trade related to their size and distance. But their relationship is even closer than expected by this fact. According to Krugman, the US and the Eurozone are both about 25% of the world economy and their trade is equal to about 2% of their economies. Whereas, China's economy in 2010 (according to Wikipedia numbers from the UN) was about \$6 trillion USD, and exports to US same year were \$283.3 billion. This is about 4.75% of the value of China's GDP that it exports to the United States. China is approximately half the size of the Eurozone, yet exports more than twice the percentage of its economy to the US, despite the historical and linguistic ties that favor US trade with Europe over US trade with China. Conversely the US exports even less than expected to China. At only 2% of US GDP going to Europe, we might expect around 1% (as China is half the economic size of Europe). However the actual figure is considerably smaller, closer to 0.61% of the US' GDP (according to Wikipedia figures). Europe has twice the GDP of China, enjoys cultural, historic, and linguistic ties to the US, enjoys the use of a single currency, and geographically has similar access to the US market, yet China sells more than twice the percentage of its GDP to the US

that Europe does.

So what is causing this relationship to be so strong? One could look at the distortions of the Chinese and US economies and draw different conclusions. One is that the pre-existing distortions are complementary and therefore the countries engage in large trade. Another is that they are reinforcing, and that each country's distortions are exaggerated by the other. These are not mutually exclusive. A third way of looking at it, proposed by Niall Ferguson and Moritz Schularick and referred to as 'Chimera' is that the two countries represented something like a single economy from 2000 to 2008, a relationship ended by the financial crisis.^[26]

The Chimera is a mythological animal, part lion, part goat, part snake. Wikipedia also states that 'chimera' is used to describe something wildly implausible, so the authors see this relationship as unsustainable. Niall

Ferguson (Harvard Professor) explains: "My friend Moritz Schularick and I came up with the idea of "Chimerica" back at the end of 2006^[26]. We were trying to explain the global financial boom, with its correlated upward movement of virtually every asset class. We decided the answer was that China and America had effectively fused to become a single economy: Chimerica. The Chinese did the saving, the Americans the spending. The Chinese did the exporting, the Americans the importing. The Chinese did the lending, the Americans the borrowing." As the Chinese strategy was based on export-led growth, they had no desire to see their currency appreciate against the dollar and gradually accumulated the massive amount of reserves they have today in an attempt to control the currency markets.

There is little dispute that the US and China are (whether they like it or not) still joined at the hip. However the exact nature and scale of debt, deficit, surplus and spending etc. etc. is not so clearly defined. According to Bloomberg, China surpassed the US to become the world's largest trading nation in 2012.^[27] However headlines spouted by mainstream media outlets are known to be highly questionable. When using GDP as a measurement method we must be very careful. Simon Kuznets who devised the system in 1934 for a US Congress report even stated that it should not be used as a measure of welfare. Since that time economists have adapted the GDP computation method and there are three key ways it can be calculated:

- The expenditure method.
- The income method.
- The value-added method.

The US economy is arguably the world's most advanced, and services therefore play a larger role in it than in other economies. Furthermore, the US banking industry is large advanced and innovative. The global recession of 2008 began due to Wall Street's packaging of domestic home loans into financial instruments that were sold worldwide. When the US housing bubble burst, and the quality of loans turned out to be poor, the problem became a contagion that affected financial institutions worldwide. Furthermore, the US has a low savings rate. Arguably, this is policy-driven, since the mantra in the US is that consumers represent two-thirds of the economy and that every slowdown, from whatever cause, can be fixed by getting people to spend.

Compared to China, the US has a very low savings rate, and it is also a seller of financial instruments. However it should not be overlooked that undersaving can also be called overspending. Because of borrowing, for the US, the expenditure method of GDP calculation will give a larger result than the other methods. By way of example we present here some statistics calculated by Dr. Steven Kates, an economics lecturer at RMIT Melbourne, Australia. He came to the conclusion that by the income and value-added methods of GDP calculation Australia has been in a heavy recession. However:

“The income series... indicates a pretty minimal year all round... Both the September and December 2008 quarters showed an actual fall in the level of output, the very definition of a technical recession. Over the year, the level of GDP has fallen 0.4 per cent, by no means as bad as elsewhere, but more in keeping with the general experience across the economy. The third measure shows the changes in GDP according to the production-based data... Here, too, [in the value added, or, production series] we have the ingredients for a technical recession, with an actual reduction in

the level of output in both December 2008 and March 2009. Across the year, GDP has fallen by 0.7 per cent.” [28]

“While the stimulus package appears to have been able to distort one of the three sets of national accounting measures we use... beneath it all the Australian economy, in keeping with the rest of the developed world, has gone through a recessionary phase from which it is only now beginning to emerge.” [28]

This means that the best way for a Government to claim it has successfully “avoided” a recession is to use the expenditure method. This way the spending of QE and other easing methods work to support the expenditure statistics.

In China however it is a very different picture. The bottomline there is a high private savings rate. On the one hand, the savings help to power economic growth, but on the other hand, they represent a reduction in aggregate demand. A key characteristic of the Chinese economy is the aggregate demand gap. There is not enough demand for goods and services domestically to employ all the workers available. China’s household consumption as a share of GDP is amongst the lowest in the world and to avoid widespread unemployment an expenditure gap needs to be bridged by a high rate of government investment.

Furthermore we have the questionability of Chinese figure reporting. If we consider the iPod example, 100% of the price of an iPod is attributed to China. But it contains chips from Taiwan, a screen from Korea, and most of the profits accrue to Apple in the US. It is estimated that Chinese contribution of Chinese exports to the United States are overstated by 60-70%. China only actually receives \$3.70 from the final wholesale price of \$224, the same goes for many cellphones and computers manufactured in China.

Further complications arise when local, municipal and provincial figures sum up to a figure greatly in excess of national figures! This is due in part to the difficulty of narrowing down what value was added where when manufactured goods cross local borders in production. Also, local politicians have an incentive to exaggerate the GDP of their regions as they are

promoted according to growth. Since GDPs of localities are overstated, so are local growth rates. Although national GDP in the PRC is calculated by a separate government agency using different data sources, this is not really a problem for our discussion, though it does lead to a general distrust of China's numbers. Finally, even if the Chinese GDP figures are accurate, according to Spratt Financial Management, stripping out imports of Gold Bullion from the Chinese GDP import statistics reduces the total import figure by around 37%^[29]. This is hardly what we would call a growth in services and products for the home market.

To some extent, the enormous trade between China and America indicates an integration of their economies. To the extent that it doesn't, it in part exaggerates the existing peculiarities of each economy. The Chinese lack a safety net, and arguably oversave individually while overspending on public projects. The Americans are in a policy rut of encouraging consumers to overspend while the government also runs deficits and sells treasury bonds to foreigners. The wealth created by trade between the two nations has in part gone into perpetuating and expanding these national features. While neither country can realistically blame the other for these features, they can each reasonably point to the exaggeration encouraged and facilitated by trade with the other.

Conclusion

Understanding the driving forces of today's international markets is difficult and highly complex. It is clear that there are symbiotic relationships at work, and in this we see a convergence of ideology and economic practices, even if only because of a common goal of profit (or self-preservation). The US is implementing increasingly socialist welfare practices (Obamacare is just the tip of the iceberg) and the PRC is implementing more capitalist reforms (albeit quite haphazardly). But where does it end and how healthy is it? If convergence naturally occurs then what purpose do barriers to trade really serve? Of course economic models suggest things like distribution of wealth, protecting infant industries, consumer protection, domestic employment protection, and uncertainty about global economic conditions. But distinguishing between corrective and protective action is highly subjective.

Within the media storm that constantly reminds us how indebted the US nation is to China, we

must remember some other important facts. Like the fact that the largest holder of U.S. debt is *not* China, but actually the Federal Reserve Bank (a privately owned institution, not a Government Agency), China is only the largest foreign debt holder. Furthermore, as Peking University Professor Michael Pettis rightly points out:

“The argument that the U.S. is borrowing from China to fund the fiscal deficit is nonsense. Economically speaking, the U.S. doesn't borrow from China. China exports capital to the U.S., and when it does that, it buys U.S. Treasury securities. Doing so doesn't give China leverage over the U.S. as much as it ties China to the overall success of the U.S. economy.”^[30]

So who holds the most debt, or who is in the most debt becomes more of an academic question, especially when you can pay the bills tomorrow, or even today if you just print the money. Something that is of consequence to all of us as individuals however, is that with the onset of international finance tools like Government Bonds and Treasuries, global organizations like the BIS, IMF and UN, combined with the flexibility of currencies no longer restricted by precious metal backing we have seen a rise in the use of future labor (GDP deficit) and future value of currency (speculation) as an exchange medium.

The most interesting, and perhaps dangerous, aspect of international monetary relations is that of future value. A nation trading at a deficit by using government bonds is in effect selling its future labor capital, that is to say the labor of its future generations. Your children, my children, our children. It is already a

well-established fact that most countries that have burdensome social welfare programs like public health, pensions etc. will soon be unable to fund these using present fiscal and monetary means. For example in the year 2000 the PRC established a national pension fund, however to date only around 365 million Chinese people have a formal pension. Even in a nation of savers the system is in dire straits (especially if we remember that by 2050 one quarter of the population will be over 65). The Economist^[31] reports that the present unfunded pension liability is close to 150% of GDP and furthermore that similar local government

schemes are also in the red and have already begun to renege on payments. What is not being discussed is how they (governments both Western and Occidental) will be funding these schemes, and who will be footing the final bill.

Before going further however we must review the discussion about trade deficit or excess. Pascal Lamy (WTO Director-General) when speaking about the US China situation states ^[32] sums up the situation very concisely:

“The statistical bias created by attributing commercial value to the last country of origin [for GDP calculation] perverts the true economic dimension of the bilateral trade imbalances. This affects the political debate, and leads to misguided perceptions. Take the bilateral deficit between China and the US. A series of estimates based on true domestic content can cut the overall deficit – which was \$252bn in November 2010 – by half, if not more.”

In addition to these blatant accounting discrepancies, anomalies and, occasionally outright lies, we posit that there is inherent instability brought about by modern trade methods that disfigure the actions of the free market making it seem like a less appealing solution than it really is. Our concerns are expressed best (and in greater depth) in a study by Dr. David Korowicz ^[33] where he acknowledges the intimate relationship between global systemic banking, monetary and solvency crises, and the effect of its implications on the real-time flow of goods and services in a global economy. He also acknowledges that it is entirely possible that any contagion in the financial system, especially between the US and PRC could easily trigger semi-autonomous contagion in global supply chains. He says “The cross-contagion between the financial system and trade/production networks is mutually reinforcing.”^[33]

The speed size and connectivity of the global market means an increased ability for supply chain failure or financial failure to be transmitted. The more complex and interdependent the economy, the fewer the failures required to transmit a cascading failure. In today’s high speed world with HFT trading algorithms, automated stop losses and the ability to short an entire nation's top 500 companies with the click of a mouse, single points of failure are becoming obfuscated and we are forgetting just how tenuous the thread is that we hang by. Treating

these complexities as normal is a trap that we as traders, politicians, economists and responsible citizens must not fall into. While the risk of such a cascade failure increases every day (especially with the DOW at its highest point since 2008 with no fundamentals to support it), and the ability to detect them decreases; the idea that we are in control and can plan for system failure would be laughable if it were not such a serious possible outcome.

Love or loathe it we are all intricately involved in this complex system of dependency where there is tremendous risk for all global traders who have a relationship with China or the US. Neither wealth nor geography is a protection, and in the case of total systemic collapse the Gravity Model would likely work both ways, meaning that those located closely to the primary default centers would also be hit worse. Our evolved co-dependencies mean that we are all in this together.

To truly comprehend the degree of systemic risk present in the globalized economy, one must understand the growing complexity in terms of connections, dependencies and speed of processes. Furthermore delocalization of production and concentration within a few pivotal nations has magnified global vulnerability. These issues have not been recognized by modern governments and policy-makers nor are they reflected in present economic thought or models. However it is interesting to note that Karl Marx and his collaborator Frederick Engels description of capitalism in the *Communist Manifesto* is “a society that has conjured up such gigantic means of production and of exchange, [that it] is like the sorcerer, who is no longer able to control the powers of the nether world whom he has called up by his spells.” While they were not exactly what we would call advocates of a free market, the truth of their statement does bear some reflection when the greed that triggers protectionism reaches so far into the bowels of the market that all past economic indicators of growth or recession are violated and no longer have any significance.

If the US does choose to pursue its current policy and engage further in a battle with the PRC over who can inject the most capital to their own home market this would really be a form of fiscal suicide. We suggest that each nation should continue to play to its strengths, after all, this is what competitive advantage is about. The US which was built on freedom of movement of capital, resources and personal opportunity should make every effort to preserve this

legacy; and China who has succeeded thus far with its gradual unwinding of its central planning approach should continue slowly but surely along its path. The deleveraging the PRC faces in the coming decade will probably still be painful but hopefully less bad than a “rip off the bandaid” approach that would be the result of a financial collapse.

In conclusion, despite the horrific manipulation of statistical figures, the poor outlook for growth globally, the overleveraging of all economies, and the general lack of true credit worthy collateral, the outlook is not all bleak and wintry (or maybe not *quite* as bad as Dr. Korowicz visualizes). This issue of protectionism is not a new one as evidenced by David Hume’s writing in 1752 in his paper titled “Of The Balance of Trade”:

“It is very usual, in nations ignorant of the nature of commerce, to prohibit the exportation of commodities, and to preserve among themselves whatever they think valuable and useful. They do not consider, that, in this prohibition, they act directly contrary to their intention ... The same jealous fear, with regard to money, has also prevailed among several nations; and it required both reason and experience to convince people, that these prohibitions serve to no other purpose than to raise the exchange against them, and produce a still greater exportation.” [34]

His argument about restriction of goods creating higher demand is so wonderfully simplistic in its microeconomic style that when applied it is some wonder how, and why, we have come to the point where we are in modern economics. A place where things have become so complex that it is no longer enough for a nation or a collective of people to simply spend time doing what they are best at and then offering this in trade for other things. It would perhaps behoove our great leaders (or at least the policy makers, as the two are rarely the same) in this modern age to read a little further into Mr. Hume’s 260 year old paper until they reach the following paragraph:

“These errors, one may say, are gross and palpable: But there still prevails, even in nations well acquainted with commerce, a strong

jealousy with regard to the balance of trade, and a fear, that all their gold and silver may be leaving them. This seems to me, almost in every case, a groundless apprehension; and I should as soon dread, that all our springs and rivers should be exhausted, as that money should abandon a kingdom where there are people and industry. Let us carefully preserve these latter advantages; and we need never be apprehensive of losing the former.” [34]

Indeed a nation with productive people and industry need not worry about losing wealth. In fact wealth can be completely disregarded if there is a truly productive economy as one will give birth to the other. There is

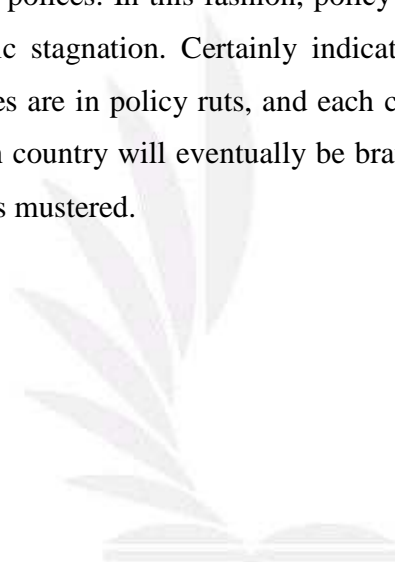
a fine line between monitoring an economy to ensure its continued health and wellbeing; and what we are experiencing now, governments enthusiastically “helping” us and “protecting” us. Government economic policy has become like the proverbial “watching mother” hovering constantly over her child, not trusting and allowing the child to develop and learn for itself. “Nanny-states,” (that is states that over-govern) and their accompanying “house rules” being issued “for your own good” only serve to hamper new industry and innovation. Trying to create something out of pure determination and money printing is a disaster waiting to happen.

What our global economy really wants and needs, is a new and more productive economic generation. Adding zeroes to a currency does not increase wealth. The thing to change must be attitude and willpower to try something different. The power to change. But, just as China cannot make Americans savers, and America cannot make the Chinese spenders each nation and individual must consider its own path forward. Each must take responsibility for economic issues stemming from the policies it pursues. Politicians on each side can do little to inspire the other to change.

In personal development, they say “change comes from within”. For changes in policy, we can say “change is domestic”. In this (US / PRC) codependent international relationship, each country must be prepared to change by itself or become tied to the stability of a partner whose destabilizing faults it well understands. As we well know the worst thing an addict can have is

an enabler. Current trends toward increased savings in America, due to the recession, and higher wages over time in China, suggest that each country is independently moving in the right direction. However, it is sobering to think that in the US the entrenched mindset that contributes to its problems still exists, not just in society but in policy too for an example we need look no further than QE, QE2 & QEternity. And in China, the entrenched interest groups and social forces leading to low wages and the poverty gap still exist. As a side note here, Chinese press reported this week that Chairman Mao's granddaughter is now worth some \$834 million USD. If we wondered before where China's disposable income for its lower classes is going, perhaps this sheds some light.

Thus there is still the palpable danger that any economic improvement will be met with the heightening of existing bad polices. In this fashion, policy inertia could conceivably continue to lead to further economic stagnation. Certainly indicators on all sides of the world are looking grim. Both countries are in policy ruts, and each country sees clearly the folly of the other. Let us hope that each country will eventually be brave enough to see its own problems with the clarity the other has mustered.



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Appendix:

Part A

US / CHINA Trade History Timeline:

1970s

Feb 21, 1972: President Nixon pays a visit to China to establish diplomatic relations with China.

Nov 29, 1975: President Ford visits China, and announce the U.S interest in normalize relations with

Beijing

1977: Hua Guofeng starts "Open Door" policy, which is later incorporated in Deng Xiaopings "Four Modernizations" program

Dec 15, 1978: President of the United States announces that cutoff all the relations with Taiwan, and approve the People Republic of China.

Dec 16, 1978: China and the US signed Joint Communiqué on Establishment of Diplomatic Relations.

Jan 1, 1979: China and the U.S establish diplomatic relations; which include technology and cultural interchange and trade relations.

Jan 28, 1979: Chinese Vice-Premier Deng Xiaoping visits the US, and made a contribution for future development of China-US relations.

1978-1979: Deng Xiaoping introduces stepwise economic reforms: "The Four Modernizations".

1980s

1980: Special Economic Zones in Shenzhen, Zhuhai, Shantou (Guangdong), Xiamen (Fujian), and the entire province of Hainan

1980-1990: Great improvement of China's food security. Significant reduction of rural poverty.

1984: 14 cities in China are opened for foreign investment.

Jan 12, 1984: Chinese Prime Minister Zhao Ziyang visits the US to sign the new agreement about new cooperation in science, industry and trade.

Apr 26, 1984: President Ronald Reagan visits China for diplomatic meeting. Reagan had highlighted to desire to improve the grow relations between the US and China.

1986: China begins to attract large amounts of foreign direct investment

Feb 25, 1989: President George Bush visits China to confirmed the attention of US-China relations.

June 4, 1989: Tiananmen Square

1990s

1992: Deng Xiaoping accelerates market reforms to establish a "socialist market economy".

Jan 4, 1993: President Clinton comes into office and to promote democracy in China. At the same time he insists that Most Favored Nation trading status for China be linked to specific improvements in human rights conditions.

Sep 1993: President Clinton launches a policy of constructive engagement with China

Oct 29, 1997: President Jian Zemin visits to the United States. Develop relations between China and the US in fields of politics, economy, science and technology, culture and education, military affairs, environmental protection, and judiciary.

Jul 1, 1997: China got control of Hong Kong, and improves relations between the US and China

Apr 6, 1999: Premium Zhu Rongji is invited by President Bill Clinton to pay a visit to the US to expand relationships between China and the US.

1998-1999: Slow-down of the Chinese economy - partly due to Asian Financial Crisis.

1999: U.S trade deficit with China reaches \$68 billion

2000s

Oct 10, 2000: U.S and China Relations Act 2000 is sign for permanent trading partner

Apr 1, 2001: A US spy plane crashed into Chinese Air Force and effects the China-US relations

Oct 18, 2001: President George W. Bush attended Shanghai APEC 2001, and President of China Jiang Zemin and President George Bush 3-hour talk about China-US relations

Dec 11, 2001: After 15 years of negotiations, China becomes a member of the World Trade Organization.

Dec 27, 2001: George W. Bush grants China as permanent trade status, to develop a strong trade between China and the US.

Feb 21, 2002: George W. Bush visits China and has urge China to respect human rights

Aug 26, 2002: China announce new regulation tightens the control over

the export of missile
technology

Jul 21, 2005: Chinese government peg currency against the U.S dollar

Sep 2008: China becomes the largest holder of US debt

Feb 2009: China makes largest investment in foreign company, and

Nov 2009: China is now the largest automobile market in the world.

Feb 2011: China overtakes Japan as world's second-biggest economy.

Feb 2012: The U.S trade deficit with China rises from \$273.1 billion to \$295.5 billion

Part B

China And USA Imports & Exports

Sources: <https://www.uschina.org/index/> &
<http://www.census.gov/foreign-trade/balance/c5700.html>

Top US Imports from China,
2011 (\$ billion) *Calculated
by USCBC

Source: ITC

HTS #	Commodity description	Volume	% change over 2010
85	Electrical machinery and equipment	98.7	8.7
84	Power generation equipment	94.9	14.7
95	Toys, games, and sports equipment	22.6	-9.4
94	Furniture	20.5	2.7
64	Footwear and parts thereof	16.7	5.1
61	Apparel, knitted or crocheted	15.1	7.4
62	Apparel, not knitted or crocheted	15.0	1.8
39	Plastics and articles thereof	10.9	13.0
73	Iron, steel	8.6	18.0
87	Vehicles, excluding rail	8.1	17.0

China's Top Exports, 2010 (\$ billion)

*Calculated by USCBC

Source: PRC General Administration of Customs, *China's Customs Statistics*

HS#	Commodity description	Volume	% change over 2009
85	Electrical machinery and equipment	388.8	29.1
84	Power generation equipment	309.8	31.4
61, 62	Apparel	121.1*	20.5*
72, 73	Iron and steel	68.1*	44.1*
90	Optics and medical equipment	52.1	34.0
94	Furniture	50.6	30.0
28, 29	Inorganic and organic chemicals	43.2*	34.9*
89	Ships and boats	40.3	42.1
87	Vehicles, excluding rail	38.4	37.5
64	Footwear	35.6	27.1

China's Top Imports,
2010 (\$ billion)

*Calculated by

USCBC

Source: PRC General Administration of Customs, *China's Customs Statistics*

HS#	Commodity description	Volume	% change over 2009
85	Electrical machinery and equipment	314.4	29.0
27	Mineral fuel and oil	188.7	52.1
84	Power generation equipment	172.3	39.4
26	Ores, slag and ash	108.6	54.9
90	Optics and medical equipment	89.8	34.1
39	Plastics and articles thereof	63.7	31.3
28, 29	Inorganic and organic chemicals	58.2*	37.2*
87	Vehicles, excluding rail	49.5	74.5
74	Copper and articles thereof	46.1	55.8
72, 73	Iron and steel	34.5*	-6.1*

China's Top Trade Partners, 2010 (\$ billion)

Source: PRC General Administration of Customs, *China's Customs Statistics*

Rank	Country/region	Volume	% change over 2009
1	United States	385.3	29.2

2	Japan	297.8	30.2
3	Hong Kong	230.6	31.8
4	South Korea	207.2	32.6
5	Taiwan	145.4	36.9
6	Germany	142.4	34.8
7	Australia	88.1	46.5
8	Malaysia	74.2	42.8
9	Brazil	62.5	47.5
10	India	61.8	42.4

China's Trade with the United States, 2001-11 (\$ billion)

Notes: *Calculated by USCBC. US exports reported on a free-alongside-ship basis; imports on a general customs-value basis.

Source: US Department of Commerce; US International Trade Commission (ITC)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
US exports	19.2	22.1	28.4	34.7	41.8	55.2	65.2	71.5	69.6	91.9	103.9
% change	18.3	14.7	28.9	22.2	20.5	32.0	18.1	9.5	-2.6	32.1	13.1
US imports	102.3	125.2	152.4	196.7	243.5	287.8	321.5	337.8	296.4	364.9	399.3
% change	2.2	22.4	21.7	29.1	23.8	18.2	11.7	5.1	-12.3	23.1	9.4
US balance	-83.0	-103.1	-124.0	-162.0	-201.6	-232.5	-256.3	-266.3	-226.8	-273.1	-295.5

China's Top Import Suppliers, 2010 (\$ billion)

Source: PRC General Administration of Customs, *China's Customs Statistics*

Rank	Country/region	Volume	% change over 2009
1	Japan	176.7	35.0
2	South Korea	138.4	35.0
3	Taiwan	115.7	35.0
4	United States	102.0	31.7
5	Germany	74.3	33.4
6	Australia	60.9	54.1
7	Malaysia	50.4	55.0

			9
8	Brazil	38.1	34.7
9	Thailand	33.2	33.3
10	Saudi Arabia	32.8	39.2

China's Top Export Destinations, 2010 (\$ billion)

Source: PRC General Administration of Customs, *China's Customs Statistics*

Rank	Country/region	Volume	% change over 2009
1	United States	283.3	28.3
2	Hong Kong	218.3	31.3
3	Japan	121.1	23.7
4	South Korea	68.8	28.1
5	Germany	68.0	36.3
6	The Netherlands	49.7	35.5
7	India	40.9	38.0
8	United Kingdom	38.8	24.0
9	Singapore	32.3	7.6
10	Italy	31.1	53.8

Top Ten US Exports to China, 2011 (\$ billion) *Calculated by USCBC

Source: ITC

HTS #	Commodity Description	Volume	% Change Over 2010
84	Power generation equipment	10.8	9.70%
12	Oil seeds and oleaginous fruits	10.7	-3.10%
85	Electrical machinery and equipment	7.2	-16.60%
87	Vehicles, excluding rail	6.4	55.60%
88	Aircraft and spacecraft	6.3	10.80%
90	Optics and medical equipment	5.2	8.30%
39	Plastics and articles thereof	5	7.20%

47	Pulp and paperboard	3.8	27.10%
74	Copper and articles thereof	3.7	32.70%
29	Organic chemicals	3.5	17.80%

China's Trade with the World, 2001-10 (\$ billion)

Notes: *Calculated by USCBC. PRC exports reported on a free-on-board basis; imports on a cost, insurance, and freight basis.

Source: PRC National Bureau of Statistics

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Exports	266.1	325.6	438.2	593.3	762.0	968.9	1,217.8	1,430.7	1,201.6	1,577.9
% change*	6.8	22.4	34.6	35.4	28.4	27.2	25.7	17.5	-16.0	31.3
Imports	243.6	295.2	412.8	561.2	660.0	791.5	956.0	1,132.6	1,005.9	1,394.8
% change*	8.2	21.2	39.8	35.9	17.6	19.9	20.8	18.5	-11.2	38.7
Total	509.7	620.8	851.0	1,154.6	1,421.9	1,760.4	2,173.7	2,563.3	2,207.5	2,972.8
% change*	7.5	21.8	37.1	35.7	23.2	23.8	23.5	17.9	-13.9	34.7
Balance	22.6	30.4	25.5	32.1	102.0	177.5	261.8	298.1	195.7	183.1

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