Title:
Will The Next Cold War Be An Economic One?

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Summary:
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Article Body:
Several big stories hit the financial news this past week but the real significance of these stories were not discussed anywhere. Number one, the U.S. Congress pushed to file unfair trade practices against China, stating that the Bush administration’s quiet behind-the-scenes negotiation strategy was unacceptable as a tactic to bring economic reform to China. In another story this week, these words appeared - Rather than serve as "an apologist" for China, "I hope the administration will join this team," Sen. Lindsey Graham, R-S.C., told reporters after testifying before the Senate Finance Committee in the second hearing on China's economic and currency policies in two days.

This article reported that Congress aimed to pass bi-partisan veto-proof legislation that will force the Chinese Yuan to appreciate against the dollar. American manufacturers have claimed that the Chinese government’s unfair manipulation of their currency has hurt them and their Congressmen are listening. Then finally at the end of the week, this headline appeared in an article: “The U.S. Commerce Department announced sanctions against paper imports from China, the first time in 23 years that U.S. duty law has been applied to imports from that country.”

Reporting the above is fine, but what are its implications? Here is my view. For once, I agree that the Bush administration is taking the proper stance and their disapproval of these brash, flag-waving Congressmen is merited. When sending U.S. Federal Reserve Chairman Bernanke and the U.S. Secretary of Treasury Paulson to China only resulted in China defiantly stating that they will not allow another nation to dictate to them how they should run their economy, U.S. Congress should have gotten the hint. Instead, they escalated an already potentially volatile situation with their threats and sanctions this week.

Stephen Roach, the chief economist at Morgan Stanley warned Congress that currency valuation was far from being the sole component hurting American manufacturers. He stated that China’s cheap labor costs, burgeoning modern infrastructure and technology and growing investment in human capital and research also have greatly contributed to the burgeoning trade imbalance between China and the United States. Mr. Roach commented, "The foreign-exchange rate is not the answer, in my view. You in the Congress need to ask yourselves an important hypothetical question: How would you feel if you got your way on the Chinese currency adjustment but found that after three or four years the pressures bearing down on American workers had only intensified? As I see it, that's a very real risk that should not be taken lightly.”

Although I have vehemently disagreed with Mr. Roach’s past views on other subject matters, I believe that he is on the mark 100% this time and I’ll tell you why. U.S. Federal Chairman Bernanke has already publicly stated that everybody knows that the weak dollar is good for the U.S. government because it makes their debt cheaper and also helps to close the trade gap. So if you don’t think that the U.S. is not guilty of manipulating their own currency as well to serve their purposes then you are living in some kind of economic fantasyland. There are a whole lot of American expats living abroad that would like to see their own government do something to protect the value of their own currency instead of lecturing other nations as to how they should be managing theirs. Furthermore, this event is indeed a watershed event in the ongoing re-structuring of the world’s economies. In the past, colonized nations had bitterly complained to Europe and the U.S. about the harm their economic policies inflicted upon their economies. But now we see a 180% reversal, with developed countries complaining to emerging nations about their policies.

But this is almost beside the point when it comes to examining much more significant fallout of an open trade war with China. The reason the Bush administration is trying to negotiate quietly with the Chinese rather than take the more hard-line stance assumed by the U.S. Congress is that they know that the Chinese government holds far more important cards than the valuation of the Yuan, namely the more than one trillion dollars of U.S. dollar denominated assets that they currently hold in their reserves.

As I stated in a blog I posted about a week ago to The Underground Investor, the U.S. Congress would be foolish to aggressively alienate the Chinese government with so much at stake. The problems with the U.S. economy are much more a product of past U.S. fiscal irresponsibility than the manipulative actions of the Chinese economy and if the U.S. chooses to try to scapegoat an economic giant like China for their current problems, I believe, as Mr. Roach stated, that re-valuation of the Yuan will not be the answer. Furthermore, it is exactly these protectionist measures that the U.S. is seeking to implement that have hindered emerging markets in the past.

Instead of addressing the real reasons behind a lagging economy, protectionist measures many times seek to scapegoat another country’s economic policies for far more deep-rooted economic failures at home. Furthermore, protectionist measures often harbor and encourages domestic inefficiencies to persist instead of encouraging proactive solutions that attack the root of the problem. In fact, if the U.S. Congress pushes through their punitive measures, I can tell you right now that revaluation of the Yuan will NOT be the answer to the problems of the American economy. And despite the fact that offloading massive amounts of U.S. dollars will hurt the Chinese economy as well, there will also come a time when the Chinese government, if pushed far enough, will offload massive amounts of U.S. dollars because their strong economy will be able to absorb its negative effects much better than the weak U.S. economy.

And if they do so, the U.S. Congress will have given them the perfect excuse to do something that I believe the Chinese government is planning to do anyway. However, they will be able to do it, save face at the same time, and do it earlier than anyone expects, as opposed to having the global community heap loads of criticism upon them for what would otherwise seem to be a sudden decision that came out of nowhere. Instead of such an action being viewed as the selfish actions of a nation, it will instead by viewed as a reaction to U.S. bullying, and U.S. Congress will have given the Chinese government the perfect out.

In this case, quiet negotiations is the proper way because any other way is bound to bring harm to not only Americans in the future, but to the global economy as well. When I have blogged about governments being chronic liars in the past, certainly the Chinese government or any world government is not immune. While the Chinese government has publicly stated that they will not take any sudden actions that will greatly hurt the U.S. dollar, do you really believe that they want to hold a trillion dollars of a currency that continues to lose significant value every year? Trust me, they are planning to get rid of these dollars as soon as economically possible and behind the scenes, they have a plan in place to offload them.

Again, I can tell you why punitive Congressional U.S. measures will not coax the Chinese to assume policies the U.S. wants but only anger them. To begin, Japan is on the verge of replacing America as China's number one trading partner. If the Chinese choose to bow down to American pressure, they would undoubtedly anger the Japanese who have heavily invested in China and would be adversely affected by the Chinese government's decision to appease the U.S. Congress. Angering your number one trading partner would be even worse than angering the U.S. And this just in, even as I write this blog, in a report originating out of New York:

Today, China called the first of U.S. protectionist measures, tariffs on their paper imports, "unacceptable." China strongly demands the United States to reconsider this decision and correct it as soon as possible," China Commerce Ministry spokesman Wang Xinpei said in a statement on a government Web site.

Secondly, I believe that the Chinese government, despite what diplomatic statements they release to the financial press about being concerned not to enact any policies that will cause the U.S. dollar to fall quickly, desire to unload a significant portion of their $1 trillion dollar of U.S. dollar-denominated reserves. The Chinese government realizes that offloading significant portions of dollars, whether it is to purchase oil and natural gas for their state reserves, or the purchase of other assets, will automatically cause the Yuan to strengthen. They are not going to appease the U.S. Congress now and watch the Yuan strengthen and then see this effect multiply as they unload U.S. dollars from their reserves. I believe that this is how the Chinese will eventually allow the Yuan to strengthen – by merely cutting back on their dollar-denominated assets, something that they want to do anyhow.

With this potential trade war, it is important to ignore the preening of the U.S. Congress but to consider the implications of their potential actions instead. U.S. Congressmen are no doubt influenced a great deal by their most important constituents, in this case, large manufacturers. However, in this case, it is not the concerns of the large manufacturers that are most important. Here they serve merely as a smokescreen.

Sure, large manufacturers are being hurt right now by Chinese imports, but rather than considering this part of the equation which the financial media gives much attention to, it is more important to consider the other side of the equation that is never spoken of in the financial media. Rather than listen to the complaints of the hurt, seek out what the very wealthiest of individuals are doing to not just protect their assets as the geo-political balance progresses towards a tipping point, but how they are positioning their assets now to prepare to profit from these future crises. As is a common theme at the Underground Investor, sometimes the loudest chatter will distract you from the most important information, the information that dwells below this chatter.