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# US-China Trade War: Mixed Currency Fortunes?

*By Tomoo Kikuchi and Yohei Tanaka*

## SYNOPSIS

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## COMMENTARY

THE LAST trade war that the United States fought against the world's second largest economy was in the 1970s witht Japan. That trade war fundamentally changed the structure of the Japanese economy while the nature of the US trade deficit remained unchanged. In the early 1980s, Japan accounted for 50 percent of the US trade deficit. Today, China accounts for nearly 50 percent of the US deficit.

The Executive Order 13806 by President Trump conveys that the restoration of the manufacturing sector is a matter of national security. The dilemma of the US is to restore the manufacturing sector and the fiscal balance of the indebted nation at the same time. To resolve this dilemma and the shortage of liquidity in global financial markets, the Chinese yuan and the Japanese yen will have to be further internationalised.

### Reducing Excessive Dependence on US Dollar

Internationalisation of stock markets in Tokyo, Shanghai and Shenzhen and promotion of the Chinese yuan and the Japanese yen as settlement and clearing currencies in energy markets will reduce the excessive dependence on the US dollar in the global financial markets.

At the same time it will reduce the pressure for the US to appreciate in the long run. Moreover, China has to make a transition from an economy driven by export to one driven by consumption to solve the trade imbalance with the US.

The "America First" policy by President Trump is a response to the Obama administration, which seemingly prioritised the Wall Street over the Main Street. In his Executive Order 13806, he warns that the deterioration of the manufacturing industry has undermined the defence industry hence affecting the national security.

His task force reports that the US lost seven million manufacturing jobs (36% of the industry's workforce) from 1979 to 2017, out of which more than five million were lost since 2000.

**US Trade Deficit with China and Japan**

The US trade deficit with China has been rising since 2000 while that with Japan has been constant. By investing their trade surpluses in the US treasury securities, Japan and China more recently have become the biggest holders of the US treasury securities. The US net foreign debt amounts to 8.6 trillion dollars today.

Since 1998, when Japan's net foreign asset was US$1.3 trillion, equal to the US net foreign debt, the US net foreign debt has grown 2.7 times of Japan's net foreign asset. This is alarming for the US as China, unlike Japan, is not an ally of the US. The US and Japan have had policy dialogues and agreements over many decades to coordinate policies.

In fact, the foreign purchase of the Treasuries has declined since its peak in 2010 and became even negative in recent years. This means that foreign investors have sold their Treasuries holdings. The dilemma between the normalisation of the interest rate and the long-term goal to restore its manufacturing sector is hard to resolve as the US possesses both the largest debt in the world and the key global currency at the same time.

For the competitiveness of the manufacturing sector, a weak dollar is desirable but the monetary policy normalisation will strengthen the dollar. If the Federal Reserve lowers the interest rate, capital will flow out of the US making it hard to sustain the debt too. On the other hand, if the Fed continues to raise the interest rate, capital outflow from the emerging economies may destabilise the world economy.

**China's Challenges**

Since joining the World Trade Organisation in 2001, China's real gross domestic product has grown more than 300%, from $2.4 trillion in 2001 to $10.2 trillion in 2017. During that period, the US' real gross domestic product grew less than 40%, from $12.8 trillion in 2001 to $17.3 trillion in 2017.

The European Chamber of Commerce documents that in 2015 China produced 28% of the world's automobiles, 41% of the world's ships, 80% of the world's computers, 90% of the world's mobile phones, 60% of the world's TV sets, 50% of the world's

refrigerators, 80% of the world's air-conditioners, 24% of the world's power, and 50% of the world's steel. In 2017 China surpassed the US to become the largest oil importer in the world.

The trade imbalances between the US and China will not be resolved until China has made its transition from an export-driven economy to a consumption-driven one. To achieve this, China faces myriad of challenges at home ranging from the state-owned sector reform, rising debt problems, to liberalising the capital market.

In addressing these challenges, China will need to cooperate with the US in the manner that Japan addressed US concerns starting with the Structural Impediments Initiative in 1989, which led Japan to open domestic markets to foreign companies and made the economy driven more by domestic demand to reduce trade imbalances.

**Yuan & Yen Should be Internationalised**

Meanwhile, the Chinese yuan and the Japanese yen will have to grow in significance to supply the global liquidity shortage caused by the monetary policy normalisation and the restructuring of the US economy. The Chinese yuan will become more significant as China will continue to grow as the world's largest energy consumer.

In fact, yuan-denominated oil futures began trading on the Shanghai Futures Exchange for the first time in March 2018. Trading volumes in Shanghai have already overtaken those of the Dubai Mercantile Exchange's oil contract to become the world's third-most traded oil benchmark after Brent in London and West Texas Intermediate in New York.

The yuan will, however, not take over the role of the dollar in the near future given the multiple challenges mentioned above. Therefore, Japan should assist both yuan and dollar by further internationalising the yen as a supplementary currency for loans to emerging economies, offering yen-denominated bonds and commodity futures, and internationalising the Tokyo Stock Exchange.

This will stabilise the global financial market by reducing the excess liquidity and over dependence on the US dollar and by supporting free trade and guaranteeing liquidity of trading currencies, on which world trade rest.

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