2008

U.S. Economic Troubles May Affect U.S.-China Economic Relations

Penelope B. Prime
Georgia State University, pprime@gsu.edu

Recommended Citation

"U.S. Economic Troubles May Affect U.S.-China Economic Relations," China Currents 7.1 (Winter 2008).

U.S. Economic Troubles May Affect U.S.-China Economic Relations

November 16, 2008 Penelope Prime 2008: Vol. 7, No. 1, Articles

In recent years, but especially since the 1990s, the U.S. and China have become increasingly economically interdependent. For most of that time, both economies have been doing well, and for much of it, growing at historic highs for both. Today, the U.S. faces a potential economic downturn. Some analysts worry that it will be more severe than after the dot-com bubble burst at the beginning of this decade.

If the U.S. economy hits troubled times, what will this mean for the U.S.-China economic relationship? For many companies, investors and consumers the answer will affect decisions and prospects for some time to come.

Barring a depression in the U.S., it is argued here that overall trade flows may not be substantially affected, and Chinese foreign investment into the U.S. could even get a boost and help ameliorate the economic downturn. To be sure, China's exports to the U.S. may slow some, especially in high-end and construction related sectors, and China's economic growth rate is expected to decrease this year. But that is due primarily to Chinese domestic issues rather than what might happen in the U.S.

Before the current U.S. economic turmoil, there were already some changes underway in the two countries' economic relationship. First, the European Union recently surpassed the U.S. as China's largest trading partner. Second, issues with the quality of some of the goods the U.S. was importing from China, such as toys, led to recalls and disruptions in supply. Third, leaders in China have moved to initiate policies to build domestic demand in China in order to lower the country's reliance on exports, or external demand. Fourth, the Chinese currency peg to the dollar as been allowed to appreciate since mid 2005—to date, about 13 percent. Fifth, in addition to currency appreciation effects, inflation and other cost pressures in China have also contributed to increased prices of China's exported products. And sixth, as a result of the new "Going Out" policy, many Chinese companies are now allowed—and in fact encouraged–to invest abroad, and some of them have begun operations in the U.S.

Despite that fact that most of these trends might be expected to dampen trade, trade between the U.S. and China has continued to grow, as has the bilateral trade deficit. U.S. imports from China increased by 18 percent in 2006 over 2005, and by 12 percent in 2007. (All trade figures are from the U.S. International Trade Commission database at www.usitc.gov.) U.S. exports to China increased 32 percent in 2006 over 2005 but only 18 percent for 2007 compared with 2006. The U.S.-China trade deficit has almost doubled since 2003, and by the end of 2007, the bilateral trade deficit had sunk to over $256 billion as compared with $233 billion in 2006.

Overall, bilateral trade flows in 2007 did not respond much to the changes described, and in fact, in some cases we see the opposite result from expectations. Even imports of toys from China were up in 2007 over 2006. Perhaps the impact of these changes will be reflected in the 2008 figures when they become available, but so far, their effects are not apparent.

What happens now if income growth in the U.S. slows? Economists expect that U.S. import trade would also slow as a result of less expected overall demand. Since approximately 16.5 percent of U.S. imports originate in China (based on 2007 figures), logically this part of the trade relationship could be affected. Exports from China in certain sectors, such as furniture, have been hit by the housing problems in the U.S. Overall U.S. exports have risen with the falling value of the dollar. Exports to China should rise as well, but this effect will be constrained by the speed at which the yuan appreciates relative to the dollar. In addition, the hope that Chinese domestic demand could substitute for a decline in exports seems unlikely any time soon. Consumption as a share of gross domestic product in China has actually fallen to less than 40 percent. This compares with over 70 percent in the U.S. economy, and over 60 percent in India. Transforming China into a modern, continental economy that drives its own growth will take more time.

The factor that could change the most as a result of a U.S. recession is Chinese inbound capital flows. As asset prices fall here, they become attractive to foreign investors generally, and Chinese investors will not be left out of the market this time. In addition, the exchange rate continues to move in the favor of foreign investors. These inflows would be the result of company investment, as opposed to the Chinese government buying U.S. treasury bills, as the falling value makes the dollar less attractive for government reserves relative to the Euro and others. Hence we can expect an additional boost to Chinese companies looking to the U.S. to do business, and to invest in assets of all types. This inward investment could very well help soften the potential economic downturn in the U.S.

In conclusion, U.S.-China trade flows appear unlikely to change a great deal due to the U.S. economic troubles; however, Chinese foreign direct investment could increase in the coming months. Therefore it is also unlikely that the U.S.-China trade deficit will decrease substantially any time soon.

Going beyond the U.S., if there are also slowdowns in the other advanced economies, such as the European Union, then there is little question that the effect on China and other countries that rely heavily on exports will be severe.