China's Economic Cyclone

By Greg Mastel

Its state-owned enterprises are a dark cloud over the global economy.

The Trump administration's decision to tackle the international trade problems of the steel and aluminum industry has sparked a vigorous debate. Intense arguments have been made about "protectionism," "free trade," and "national security." Each of those debates is legitimate, but they miss the central dynamic driving international trade distortions in steel, aluminum, and numerous other sectors.

The blame for current trade problems in these key sectors lies in Beijing, not in Washington. The global problems in steel and aluminum are mostly due to the dangerous industrial policy China has pursued in these sectors largely through its state-owned enterprises.

AN ECONOMIC CYCLONE CREATED IN BEIJING

In its Section 232 national security analysis, the U.S. Commerce Department focused on a number of countries. It is certainly true that U.S. imports of steel and to a lesser extent aluminum come from a number of countries. Steel problems, in particular, have been an issue between Washington, Tokyo, Seoul, and Brussels for decades.

Since 2000, however, the global trade problems in steel, aluminum, paper, chemicals and many other sectors have been made in China. The picture in steel is particularly stark. In the twenty-first century, China has become the world's largest producer and exporter of steel. According to work by the Duke

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University Global Value Chains Center drawing on the work of the OECD, since 2000 China has added more steel production capacity than the rest of the world combined. China now accounts for almost half of the world's excess production capacity of steel. Since 2000, China's share of global production of primary aluminum has gone from just 11 percent to well over 50 percent. This sort of relentless growth in production and exports inevitably devastates the global market.

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IMPACT ON THE U.S. MARKET

For some products, notably stainless steel, the impact of Chinese production on the U.S. market is direct. Stainless steel produced in China comes directly into the U.S. market and displaces U.S. production and U.S. workers.

In many cases though, the picture is more complex. Because of the transportation realities and because Chinese steel products are often the target of antidumping laws in the United States and other developed markets, Chinese steel sometimes does not find its way directly into the U.S. market. But the tidal wave of Chinese production since 2000 still has an enormous impact. First and foremost, the rising volume of Chinese production, which has increased regardless of market signals, depresses global prices and as a result U.S. prices for industrial products.

The constraints on Chinese steel often mean that it is exported to third markets rather than the U.S. market.

The rising volume of Chinese production depresses global prices.

But those Chinese exports displace steel production by other countries, such as Brazil, Turkey, and India, into the U.S. market. Indirectly, the surging U.S. steel imports are largely due to Chinese production flooding into the global market.

WHY IS CHINA OVERPRODUCING?

Both steel and aluminum are mature products and the global market for both products has been threatened by overcapacity for decades. If decisions were made by market entities, these production expansions would be incomprehensible.

The production decisions, however, are primarily made by Chinese state-owned enterprises and the bureaucracies that surround them, which respond to different factors. In 2013, Usha and George Haley produced an impressive analysis of the role of state-owned enterprises in driving industrial decisions in China. China probably originally saw production of industrial products, like steel and aluminum, as signs of national strength. But the injurious twenty-first–century growth seems driven by an endless effort to build China's production in large part to sustain employment in industrial sectors. In other words, China's relentless production building may be better understood as a strategy to export unemployment rather than one aimed at exporting steel and aluminum. These are decisions that can only make sense in a non-market economy.

China's state-owned enterprise sector is a dark cloud hanging over the world economy. The enormous debt and inefficiency of China's state-owned enterprises is a real threat to the Chinese economy. But the unemployment-exporting machines now impose a massive cost in lost production and jobs on the rest of the world.

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with Beijing? This is a looming possibility. As early as 2012, the People's Bank of China and the United Arab Emirates Central Bank set up a US$5.5 billion currency swap, setting the stage for footing the bill for Chinese oil imports from Abu Dhabi in CNY.

Indeed, diplomatic and economic ties between China and Saudi Arabia have been strengthening since 2016. Leaders of both countries have already made no less than four official visits in the past two years. While this may be largely rhetoric, there seems to be synergy between China's Belt and Road Initiative and the "Saudi Vision 2030" roadmap. This potential bilateral deal is reportedly worth as much as US$70 billion with a strong focus on oil.

What if Saudi Arabia begins settling some of their oil transactions in CNY with Beijing? This is a looming possibility.

Saudi Aramco is currently preparing what is potentially the largest initial public offering in financial history. The valuation of it ranges from US$1 trillion to $2 trillion. Offering 5 percent of the company for IPO is equivalent to US$50 billion to $100 billion. Potential Chinese strategic investors include PetroChina and Sinopec, which were reportedly interested in acquiring the complete offer. If this happens, it could possibly lead to the cancellation of the IPO. Elsewhere, Saudi Aramco looks set to work with Chinese state enterprises, such as Norinco and Aerosun Corporation, in projects such as oil refinery, construction of chemical plants, oil pipelines, and more. Saudi Arabia and the Emirate of Sharjah have also recently announced plans to raise funds directly in China's onshore Panda bond market.

THE ROLE OF GOLD

Gold is a key element of the petro-CNY system. It is important to make offshore yuan convertible into gold since the availability of investible assets is vital in safeguarding the interest of CNY recipients. That partially explains the tactful accumulation of gold reserves by China, which have jumped almost threefold since 2007 in tandem with the growing bilateral oil trade.

Russia has already set up a branch of the Bank of Russia in Beijing. Technically, Russia can use its yuan proceeds to buy gold via the Shanghai Gold Exchange. It is also reported that China will soon launch crude oil future contracts priced in CNY. If China succeeds in getting Russia and Saudi Arabia to join its petro-CNY initiative, the implications for global economies and markets could be profound. Not only would this be a game changer for the dynamics of the oil trade, but the geopolitical balance could tilt as well. Some countries may be able to bypass economic sanctions under the U.S. dollar system, thereby weakening the United States' economic prowess.

Related to this, alternative settlement systems are being deepened. China launched the Cross-border Interbank Payment System (CIPS) in 2015 as an alternative to the SWIFT (Society for Worldwide Interbank Financial Telecommunication). The system has become the main channel of cross-border CNY payment in the past two years. At the end of 2017, CIPS direct participants reached 31 and its indirect participants stood at 677, covering 87 countries and regions. That includes VTB, the second-largest bank in Russia.

Moreover, the key elements of the requisite institutional infrastructure are already in place. The US$40 billion Silk Road Fund backed by China's foreign exchange reserves, the Export-Import Bank of China, and China Development Bank are all such platforms. The aim is to encourage Chinese state-owned enterprises to predominantly invest in infrastructure projects in Eurasia, while nudging participating countries toward using CNY as the currency of settlement.

The petro-CNY system backed by gold or sovereign bonds does not require full CNY convertibility to function.

It is reported that Pakistan, an important strategic partner in the Belt and Road Initiative, is taking related measures to establish the CNY as the settlement currency for bilateral trade and investment transactions with China. In recent months, the State Bank of Pakistan has introduced regulations pertaining to letter of credit issuances

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A POLICY RESPONSE?

The preferred strategy for addressing this problem would be to convince China to reform its state-owned enterprises. Certainly, endless efforts and promises have been made toward this end. The reality, though, is that little progress has actually been made. As the statistics cited earlier demonstrate, for industries such as steel and aluminum, the problem has grown much worse.

China seems now to be more inclined to increase the state role in the economy, not decrease it. The promise of reform through increasing discipline and merging Chinese state-owned enterprises seems little more than vague promises to rearrange the deck chairs on the *Titanic*. China's World Trade Organization entry in 2001 could well prove the most serious international economic policy error the United States has made in the twenty-first century. It certainly demonstrates that China is more likely to change international institutions than it is to be changed by them.

China's relentless production building may be better understood as a strategy to export unemployment.

That leaves the world to consider "second-best" solutions. In the United States and Europe, this has meant continuing to treat China as a non-market economy, which it clearly still largely is, under their respective trade laws. Trade actions under Section 232 can also be forged into remedies for trade problems with China. None of these are elegant perfect solutions, but absent dramatic political change in China, they are what is possible. ◆