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## Confronting China – Is it so Difficult?

For years, global “experts” have not been shy in telling countries how to administer their international trade and financial policies. One positive fallout of the current world-wide economic downturn may be that those experts are rethinking some of their most cherished doctrines.

As an example, for years a fundamental tenet of the International Monetary Fund has been that its member countries should not impose controls on capital movements, particularly inflows of foreign investment. The thinking was that limiting foreign investors to minority interests in local companies or prohibiting outright investment in certain sectors would hurt the host country in the long run. Recently, however, the Fund has been considering a more nuanced and situation oriented approach. The reason for this change? Empirical experience showing that some countries rejecting the Fund’s advice fared better than those that accepted it:

On the one hand, economic literature provides evidence that free capital movements help channel resources to their most productive uses, and increase economic growth .... On the other hand, recent crises demonstrate that capital flows can create risks to individual members and the system more generally. [IMF, *The Fund’s Mandate*, Feb. 22, 2010.]

There are also recent signs that “experts” on international trade are rethinking some of their most fondly held positions. We have commented many times that the defenders of absolute free trade like to label their opponents as “protectionist”, no matter that the international rules and domestic law permit defenses against injurious, unfair or disruptive imports. However, that name calling has not thwarted domestic firms and workers from seeking and, in meritorious cases, securing relief.

The same rules and laws that give redress against unfairly traded imports also permit exporting countries to challenge adverse rulings at the World Trade Organization. The U.S. has defended its actions in many such appeals and has instituted a number of its own against other countries' restraints. While there is some concern that the reviewing panels at the WTO are more prone to rule for exporters than their domestic competitors, on balance the process works fairly well to make sure all play by the rules.

The WTO structure is applicable to trade in goods and services, but it does not cover currency relationships that may affect that trade. Thus, for example, China is free to appeal actions against its exports to the U.S., but we have no place to go to protest China's valuation of its yuan. Recent analyses have shown how China has used this discrepancy to its advantage. The *New York Times* recently reported that China has filed more cases with the WTO than any other country, while it has labored to suppress IMF studies showing how it has undervalued its currency, even though those studies, unlike WTO rulings, carry no compulsory requirements. According to the *Times*, the Fund staff has concluded that the yuan is "substantially undervalued", *i.e.*, by more than 20% of its fair market value.

Undervaluing a currency has the same trade-distorting effect as giving subsidies to exports, which is prohibited by WTO rules. Thus, the Chinese have seized upon a huge loophole in the international rules to promote their exports (which outstripped imports by \$198 billion in 2009).

What is interesting about this story is that even the free traders have begun to cry "foul". Some have suggested that the WTO get involved; although the legal framework for such action is not clear. Others have suggested more direct measures, like a surcharge on Chinese imports. Paul Krugman, the Nobel economist who terms China's currency policies the "most distortionary" in history, has suggested a surcharge of 25%.

The Chinese have begun to notice. Premier Wen Jiabao called for an end to "finger pointing", which he attributed to other countries trying to increase their own exports through currency manipulation. Even in the land of pots and kettles, this is a surprising bit of hypocrisy.

Some fear that taking strong measures against China would endanger the dollar, as China could choose to dump its holdings and depress our currency world-wide. Krugman points out that a cheaper dollar would aid U.S. exporters and would severely injure China, as its holdings became worthless. He is obviously in favor of calling China's bluff, and maybe that is the only way out of the current predicament.

Here are this month's cost data:

- Scrap and Pig Iron Prices for #1 dealer bundles and #1 busheling (Chicago) have continued their sharp rise. The former now stands at \$440 per mt and the latter at \$460. These are now the highest prices since the spike in mid-2008, which ran aground as the sub-prime bubble burst. Otherwise, they are the highest prices ever. The spot price for Brazilian pig iron (cif New Orleans) has reached \$440 per mt, again the highest price ever, apart from mid-2008.
- Natural Gas Natural gas prices took a dive this month, dropping \$1.07 to \$4.47 per mmBtu. That level is back in the range of the very low prices that held sway for most of 2009.
- Ocean Freight The Baltic Capesize Index has continued to hover at the lower end of its history since 2003. This month, it was at 3871, a slight increase from February.
- Exchange Rates As of this writing, the euro is unchanged from last month at \$1.35, the pound has dropped five cents to \$1.50, and the Canadian dollar has strengthened three cents to \$0.98.

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