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A U.S.–China G-2: Today, It's Closer to a G-0

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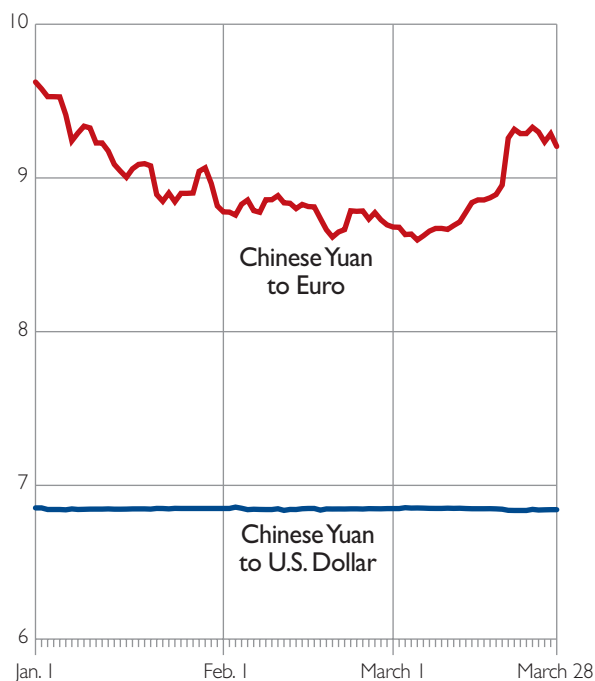
The G-20 convenes again this week, once more generating high hopes that progress can be made in addressing the economic crisis. Due to its size and diversity, the G-20 is an unwieldy body. Hence much of the media spotlight has shone on smaller groups, such as the U.S. and Western Europe.¹ Some observers have focused on the U.S. and the PRC as the world's largest and most extensive economic relationship, a G-2.²

The Sino–American economic relationship is exceptionally important. There is scant evidence, however, to expect enough cooperation from the G-2 to resolve the crisis. Rather, the two countries seem to be moving further apart.

Distance in External Policies. There are few reasons for optimism about a Sino–American G-2. Initial claims that China was immune to the crisis or, even further off base, would lead the world forward have thankfully, if belatedly, been discredited.³ There remain variations on the view that Beijing can be helpful in a supporting role to the global economic leader, the U.S. Such notions have always been implausible and now are increasingly so.

At the G-20, Presidents Obama and Hu are scheduled to announce a new mechanism for bilateral negotiations, replacing the Strategic Economic Dialogue.⁴ Until and unless this mechanism yields results, it will be another venue for empty talk. China's pledge to assist the IMF in some notable fashion is a genuine cooperative step.⁵ Washington's response will probably be announced soon

Currency Conversion Rates in 2009



Source: Oanda.com, FXHistory®: historical currency exchange rates, at <http://www.oanda.com/convert/fxhistory> (March 30, 2009).

Chart 1 • WM 2374  heritage.org

This paper, in its entirety, can be found at:
www.heritage.org/Research/TradeandEconomicFreedom/wm2374.cfm

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thereafter, as the Department of the Treasury is unlikely to cite Beijing as manipulating the yuan.

This is a reasonable position, since China's currency policy is the same as many other countries: a peg to the dollar. Even the pretense that the peg was lifted back in 2005 has been abandoned in the last few months, when the yuan has not budged against the greenback.

The problem is not broad currency "manipulation" or the dollar peg itself. The problem is the peg in the context of the huge, persistent bilateral trade imbalance.⁶ While posturing against protectionism,⁷ Beijing refuses to let the price governing trade with the U.S. adjust to restore equilibrium in that trade—hardly the hallmark of a good partner. In fact, by using a tighter peg to clutch more firmly to its bilateral trade surplus, China is becoming an increasingly bad partner.

Examples of fresh Chinese behavior include Beijing's recent call for the dollar to be replaced as the world's reserve currency.⁸ Many countries can legitimately and loudly complain about the dollar and American policies behind it; the PRC cannot. Its chosen balance of payments system has played in

important role in the recent evolution of the dollar regime. Without taking long-overdue steps to alter its own system, China is asking the entire world—but especially the U.S.—to accept the adjustment costs necessary to replace the dollar.

On the investment side, stability reigns, for better and worse. The State Administration of Foreign Exchange continues to buy American bonds.⁹ Foreign companies continue to be unable to buy Chinese companies, as demonstrated with the rejection of Coke two weeks ago.¹⁰

But the Coke fiasco serves as an immediate reminder that Washington, too, is playing a role in pushing the U.S. and PRC farther apart. The odd, poorly justified Coke decision may be traced in part to poorly justified American rejections of Chinese investment, including but not limited to the well-known bar on CNOOC buying Unocal.¹¹ The U.S. has also violated World Trade Organization norms by applying both countervailing and anti-dumping duties to Chinese goods, when these were meant as alternatives.¹²

Disconnect in Internal Policies. Those who see or advocate a closer Sino-American partnership

1. Nile Gardiner, "Barack Obama's European Tour: The President Must Protect the Transatlantic Alliance," Heritage Foundation *WebMemo* No. 2370, March 30, 2009, at <http://www.heritage.org/Research/Europe/wm2370.cfm>.
2. Robert B. Zoellick and Justin Yifu Lin, "Recovery Rides on The 'G-2,'" *The Washington Post*, March 6, 2009, at http://www.washingtonpost.com/wp-dyn/content/article/2009/03/05/AR2009030502887_pf.html (March 31, 2009); C. Fred Bergsten, "A Partnership of Equals," *Foreign Affairs*, July/August 2008, at <http://www.foreignaffairs.com/articles/64448/c-fred-bergsten/a-partnership-of-equals> (March 31, 2009).
3. Derek Scissors, "China's Stimulus Plan: Repackaged and Misdirected," Heritage Foundation *WebMemo* No. 2128, November 10, 2008, at <http://www.heritage.org/Research/AsiaandthePacific/wm2128.cfm>.
4. China, U.S. Agree on Form of New Dialogue," Reuters, March 23, 2009, at <http://www.reuters.com/article/topNews/idUSTRE52M16520090323?feedType=RSS&feedName=topNews> (March 31, 2009).
5. Andrew Batson, "China Seeks More Involvement—and More Clout," *The Wall Street Journal*, March 31, 2009, at <http://online.wsj.com/article/SB123837953546968375.html> (April 1, 2009).
6. The bilateral deficit fell in on-year terms in November but rose in December and again, slightly, in January, each month remaining above \$20 billion. U.S. Census Bureau, "U.S. International Trade Statistics," at <http://censtats.census.gov/sitc/sitc.shtml> (March 31, 2009).
7. Batson, "China Seeks More Involvement."
8. Zhou Xiaochuan, "Reform the International Monetary System," People's Bank of China, March 23, 2009, at <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=178> (March 31, 2009).
9. Major Foreign Holders of Treasury Securities, Department of the Treasury/Federal Reserve Board, March 16, 2009, at <http://www.treas.gov/tic/mfh.txt> (March 31, 2009). Because investment into the PRC is dropping and investment out is rising, there may be fewer dollars on hand to buy U.S. treasuries regardless of Beijing's intent or alternatives.
10. David Barboza, "China Blocks Coke Bid for Juice Maker," *The New York Times*, March 18, 2009, at <http://www.nytimes.com/2009/03/19/business/worldbusiness/19coke.html> (March 31, 2009).

typically start by noting that growth in the world's two largest (adjusted for purchasing power) economies benefits both nations, not to mention the rest of the world. This claim has been and will certainly be true again. But it is not presently true for Chinese growth.

There is a general misconception that the PRC directly contributes to global growth by virtue of its own GDP gains. One simply divides the increment to the Chinese economy by the increment to global economy to get China's contribution to the world: This is incorrect. As an accounting matter, the PRC extracts wealth from other nations via its trade surplus. The Chinese surplus enters as a positive for Chinese GDP and a negative in GDP for those countries running a deficit, especially the U.S. where the imbalance is particularly large.

Until the recent financial shock, the greater competition introduced by China's rise more than compensated for its trade surplus, which is a small fraction of global GDP. Products made in the PRC improved the availability and quality of consumer goods and permitted sustained and powerful pro-growth policies without accompanying inflation. With demand for the moment woefully inadequate, though, the lower prices and higher quality introduced by Chinese goods and services is temporarily redundant.

Far from helping, Beijing's stimulus plan exacerbates the negative aspects of China's interaction with the global economy. Local governments are supposed to provide the bulk of the stimulus but local revenue is already inadequate.¹³ That means

Annual Growth in Loan Volume

Month	Percent Change
November 2008	16.0%
December 2008	18.8%
January 2009	21.3%
February 2009	24.2%

Source: "Money and Credit Recorded Rational Growth in February," The People's Bank of China, April 1, 2009, at <http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1279> (April 1, 2009).

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the chief tool is bank lending, as seen in a loan surge since October.

Bank loans overwhelmingly go to firms, not individuals.¹⁴ Beyond just offsetting short-term costs, the loans finance investment in new production, causing investment to surge slightly from an already blistering 26 percent pace at the end of 2008, with a goal of further acceleration.¹⁵ With Chinese saving rocketing higher at better than a 30 percent annual clip, there is insufficient domestic consumer demand. More investment and more supply thus inevitably translate to more pressure to export.

Due to the structure of the American economy, where growth is associated with a trade deficit, U.S. policy is more helpful to China than present Chinese policy is to the U.S. America's outlandish budget deficit and the associated planned bond sales constitute an attack on the value of Chinese held dollar-denominated assets, which may exceed \$1.5 trillion. This is an especially indefensible blow

11. Associated Press, "China's CNOOC drops bid for Unocal," MSNBC, August 2, 2005, at <http://www.msnbc.msn.com/id/8795682> (March 31, 2009). Perhaps worse was the rejection of Bain Capital's acquisition of 3Com due to Huawei's minority role. 3Com then simply moved its headquarters to the PRC. Press release, "Bain Capital Terminates Merger Agreement with 3Com," Stanton Crenshaw Communications for Bain Capital, March 20, 2008, at http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20080320005798&newsLang=en (March 31, 2009).
12. Press release, "U.S. Department of Commerce Issues Final Affirmative Antidumping and Countervailing Decisions," Reuters, May 30, 2008, at <http://www.reuters.com/article/pressRelease/idUS204356+30-May-2008+BW20080530> (March 31, 2009).
13. Andrew Batson, "China Stimulus Tweaks Don't Redress Imbalances," *The Wall Street Journal China Blog*, March 9, 2009, at <http://blogs.wsj.com/chinajournal/2009/03/09/1391> (March 31, 2009); Report on China's Central, Local Budgets, *Xinhua*, March 15, 2009, at http://english.gov.cn/2009-03/15/content_1259811_8.htm (March 31, 2009).
14. People's Bank of China, "Money and Credit Recorded Rational Growth in February," April 1, 2009, at <http://www.pbc.gov.cn/english/detail.asp?col=6400&id=1279> (April 1, 2009).
15. "Urban Investment in Fixed Assets Kept Going up in February," National Bureau of Statistics of China, March 12, 2009, at http://www.stats.gov.cn/english/newsandcomingevents/t20090312_402544136.htm (March 31, 2009).

within the Sino–U.S. economic relationship because American *per capita* income is nearly five times greater than that of the Chinese, even controlling for purchasing power.

A Marriage of Convenience. Washington and Beijing are in a marriage of convenience, bound together by many material advantages. When times were good, neither could be bothered to address

dysfunction in the relationship. Now, each is looking to assign blame and find solutions without regard for the broader impact of these measures. Such an atmosphere is hardly conducive to establishing an effective G-2—the partnership is not strengthening, but weakening.

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