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President Obama Has a Full Plate in First Visit to China

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During his imminent visit to Asia, President Obama will stop in both Shanghai and Beijing. In the past, the benefits of the Sino-American economic relationship acted as a check against political disagreements. Unfortunately, this trip will see substantial and possibly growing economic tension.

The July meetings of the Strategic and Economic Dialogue between the U.S. and China focused on coordinating economic policy and initiating global rebalancing. Progress to these ends has been mixed, at best, and there is also increasing trade tension. The President will be hard-pressed to achieve any concrete economic cooperation.

Valuable Bilateral Coordination. Despite several daunting challenges, President Obama is, in an important sense, under less pressure than previous Presidents traveling to the PRC. There is now considerable communication between Washington and Beijing: Once rare, visits by cabinet secretaries and senior Chinese officials have become commonplace.

Recent communication between the two nations has been dominated by discussion of the policy response to the financial crisis and, increasingly, how to unwind that response. Frequent discussion helped facilitate similar policy steps by the two governments in late 2008 and early 2009. These steps, however, were harmful and dangerous in multiple respects,¹ making it vital that there be a prompt and well-implemented reversal. While there will be more disagreements on ending stimulus than there were on initiating it, established policy consultation will be useful in that regard.

Climate change—a priority for President Obama—is a more difficult element of bilateral coordination. High hopes in some quarters have been dashed by lack of progress. This is not due to lack of interest; there are extremely daunting economic obstacles blocking the control of greenhouse gas emissions by the PRC.² On the American side, government promotion of otherwise uncompetitive “green” energy has generated a series of problems.³

China Not Rebalancing Yet. It is broadly accepted that American under-saving and Chinese under-consumption contributed to the sharpness of the autumn 2008 economic downturn. The U.S. federal government budget deficit has since soared, cutting deeply into American national savings. Below the federal level, however, greater saving has essentially been forced on local governments and, most important, households.

There is as yet no matching improvement in Chinese economic structure. A central and unfortunate feature of the PRC's economy prior to the financial crisis was the transfer of wealth from households to firms through the financial system. Very low rates of return on bank savings robbed households of wealth, especially with few other options available

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for individuals and families and very low borrowing costs transferred that wealth to enterprises.⁴

The lauded PRC stimulus package intensified these transfers. The core of the stimulus was not the headline \$585 billion in promised government spending but \$1.1 trillion in new loans in the first three quarters of 2009, 75 percent more than all of 2008. To make the loans work, borrowing costs were extremely low. Such a high amount of lending in a poor climate would necessarily damage banks; their margins thus had to be shielded by paying savers almost nothing on deposits. The result: more money in the hands of firms to make things and less for households to buy things.

Another relevant crisis development is more tentative but even more disturbing: To this point, it has been universally assumed that more Chinese consumption meant more imports and, hence, smaller global imbalances. In the first three quarters of 2009, the PRC reported that retail sales rose 15 percent while imports fell 20 percent. There are several data issues but any hint that internal consumption could divorce from imports must be watched very closely. There are certainly powerful domestic business interests that will seek to secure for themselves nearly all of the benefits of stronger Chinese demand.

Contributing to weak import demand is the RMB's peg to the dollar. Beijing actually tightened the peg several months before Lehman Brothers collapsed. Its refusal to let the RMB move against the dollar during the crisis and the recent depreciation of the RMB against the euro and East Asian currencies made it notably more difficult for the global economy to adjust. This obstacle to adjustment is especially formidable, because China is the second-largest global trader and soon to become the second-largest economy. Happily, it seems that the PRC might be starting to consider a looser peg.⁵

U.S. Begins to Regress on Trade. There are bright spots in U.S.–PRC trade and investment relations. Congress has shown considerable restraint on trade given the extent and stubbornness of domestic unemployment. The Obama Administration seems to have a better understanding of important aspects of the Sino–American relationship than early in the year.⁶ And Chinese investment in the U.S. continues even outside of Treasury bonds, to the tune of \$5 billion committed, including \$1.6 billion just last week in power company AES.⁷

That is far from the whole story, however. The Obama Administration, through the Department of

1. William W. Beach. "Fiscal Challenges for Government at All Levels: How Economic Stimulus Drives Up Deficit and Debt," Heritage Foundation *WebMemo* No. 2227, January 16, 2009, at <http://www.heritage.org/Research/Economy/wm2227.cfm>; Alan Wheatley, "A Year On, China's Stimulus Postpones Its Problems," Reuters, November 10, 2009, at <http://in.reuters.com/article/businessNews/idINIndia-43832220091110> (November 10, 2009).
2. The White House, remarks by the President at the U.S./China Strategic and Economic Dialogue, July 27, 2009, at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-at-the-US/China-Strategic-and-Economic-Dialogue (November 10, 2009); Derek Scissors, "Ten Things About China and Climate Change," Heritage Foundation *Special Report* No. 68, November 2, 2009, at <http://www.heritage.org/Research/EnergyandEnvironment/sr0068.cfm>.
3. For example, Kim Chipman and John Duce, "Bar Funds for China-Backed Wind Farm, Senator Says," Bloomberg, November 6, 2009, at <http://www.bloomberg.com/apps/news?pid=20601080&sid=a3sGCD6uuJN8> (November 10, 2009).
4. Nicholas R. Lardy "Financial Repression in China," Peterson Institute for International Economics, September 2008, at <http://www.iie.com/publications/pb/pb08-8.pdf> (November 10, 2009).
5. Reuters, "China Signals That It May Allow Currency to Rise against Dollar," November 11, 2009, at <http://www.cnbc.com/id/33850971> (November 11, 2009).
6. Derek Scissors, "U.S.–China Trade: Do's and Don'ts for Congress," Heritage Foundation *Backgrounder* No. 2299, July 20, 2009, at <http://www.heritage.org/Research/TradeandEconomicFreedom/bg2299.cfm>. When Secretary of State Hillary Clinton visited in February, she urged China to buy American bonds. See Indira A. R. Lakshmanan, "Clinton Urges China to Keep Buying U.S. Treasury Securities," Bloomberg, February 2, 2009, at <http://www.bloomberg.com/apps/news?pid=20601070&sid=apSqGtcNsqSY> (November 10, 2009). This is a misunderstanding of the situation—under present conditions, the PRC must buy American bonds. See Derek Scissors, "China Is a Banker over a Barrel," Heritage Foundation *Commentary*, March 16, 2009, at <http://www.heritage.org/Press/Commentary/ed031609b.cfm>. Thankfully, the Administration has now realized this.

Commerce and the U.S. International Trade Commission (ITC), has taken a series of small, sector-specific trade actions aimed at the PRC. Tire tariffs gathered the most attention, but last week's duties on pipe were larger.⁸

These just put the fine point on a disturbing trend. In July 2008, Commerce and the ITC began to focus more narrowly on China. The ITC is the culmination point of the process. Since mid-2008, over 60 percent of ITC findings of possible trade harm have included Chinese goods, including no less than 36 such findings to date in 2009. Both the proportion and the absolute number are notable increases over earlier periods.⁹

This is absolutely the wrong way to shrink the trade imbalance and one that ultimately costs American consumers more in an already difficult time. Now that the genie is out of the bottle, it will be difficult to re-embrace open trade, especially with U.S. unemployment over 10 percent and looking to remain there for some time. If unemployment does stay that high, the restraint shown by Congress may not last, adding fuel to the Administration's small protectionist fire.

Recommendations. President Obama's first visit to China is valuable in itself. Much more value, however, would come from genuinely moving the PRC toward the rebalancing that has been discussed for the past six years. Both to make American arguments more credible and because it will benefit the U.S., the Obama Administration should offer to dramatically reduce deficit spending and halt creeping protectionism.

- Sino–American communication and coordination efforts are commendable and should be maintained;
- Climate change discussions are very unlikely to be fruitful and should be downgraded as a priority, if this has not already occurred;
- Discussions of an exit strategy from crisis stimulus are inadequate. The U.S. must push the PRC for a specific—even if long-term—restructuring plan where domestic consumption is no longer suppressed and market access is gradually improved;
- As part of this long-term restructuring plan, the U.S. should push for a much looser peg of the RMB to the dollar, moving toward an eventual free float of the RMB;
- The American federal government budget deficit should be cut quickly and aggressively, both to help the U.S. economy and to strengthen the dollar;
- The Administration should reconsider the policy directives behind Department of Commerce investigations that have triggered the rush of findings against China.

For decades, America's and China's limited understanding of each other was a serious threat to bilateral relations. Now mutual understanding is better, and the two countries are challenged to get their own houses in order while not using the other as an excuse to avoid difficult decisions.

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7. Steve Mufson, "Chinese Company to Buy a Stake in AES: Arlington Firm Seeks Money for New Projects, Ties to Asia," *The Washington Post*, November 7, 2009, at <http://www.washingtonpost.com/wp-dyn/content/article/2009/11/06/AR2009110601977.html> (November 10, 2009). See also China Global Investment Tracker: Chinese Outward Investment, The Heritage Foundation, at http://www.heritage.org/cda/upload/China_Global_Investment_Tracker.xls.
8. Doug Palmer, "U.S. Sets More Duties on China Pipe in Record Case," Reuters, November 6, 2009, at <http://in.biz.yahoo.com/091105/137/bauiify.html> (November 10, 2009).
9. Press releases, United States International Trade Commission, 2008–2009, at http://www.usitc.gov/press_room/news_release (November 10, 2009).