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The U.S.–China Economic Relationship: In Need of Counseling, Not Divorce

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The process of demonizing the U.S.–China economic relationship has begun. It is being called out both as principally responsible for our nation's economic turmoil and as driven largely by devastating Chinese policies. There is certainly bad Chinese policy to be found. The yuan is misaligned and, more important, the People's Republic of China's (PRC's) tight controls on capital movement caused global economic adjustment to be more violent than it should have been.

Unfortunately, bad American economic policy made a proportionally greater contribution to this crisis. It is vital to recall that America's economy is much bigger than China's. The U.S. is the heart of the global economy. Moreover, there are many core benefits of the Sino–American economic relationship, benefits now being recognized even by some of China's harshest critics. On the U.S. side, these benefits include cheaper goods and still-cheap capital, simultaneously, a rare and valuable combination.

Blaming China First. For his congressional confirmation hearings, Treasury Secretary-designate Timothy Geithner submitted written testimony indicating that President Obama considers China to be manipulating its currency.[1] This testimony should be considered the first shot in a trade battle that has been looming since the start of the current economic crisis.[2]

Geithner's comments immediately sparked a debate over the role of Chinese policy in U.S. economic performance, with assessments ranging from principal blame for the PRC to no blame at all for the PRC.[3] One of the reasons for the sharp divergence in views is the availability of easy targets when attacking Chinese economic policy.

From the end of 2004 to the end of 2008, the yuan climbed more than 17 percent against the dollar and more than 14 percent against the euro.[4] In the same period, however, China's overall trade surplus went from \$32 billion to \$295 billion, an increase of more than 800 percent.[5] The currency movement has been insufficient.[6]

Another source of confusion is the, sometimes belated, recognition that the U.S. gains even from bad Chinese policy. One reason for the dangerous explosion in easy credit in the U.S. was the Chinese buying American bonds with proceeds from their massive trade surplus. This recycling was forced ultimately by the PRC's capital controls, whereby the foreign currency earned from exports cannot be freely used within China. Such currency can only be spent abroad and American bonds are the only market that can absorb \$250 billion or more each year.

The closed-capital account has been trumpeted for years in Beijing as a great contributor to stability. As with all state attempts to control the market, it merely postponed the day of reckoning. Rather than

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addressing the ongoing minor instability of free capital movement across its borders, the closed-capital account and forced recycling contributed to the biggest patch of instability for the PRC since Tiananmen Square.

But Chinese politicians are not the only ones caught on their own hook. The principal advocates of trade action against China may have just recognized that the trade deficit the U.S. runs finances Chinese purchases of American bonds. Consequently, such purchases may now appear indispensable in light of plans to greatly expand the U.S. budget deficit.[7]

Contradictions. There is rhetorical and policy inconsistency on both sides of the Pacific because assigning blame runs headlong into the fact the U.S. and China both want to enjoy the benefits of their irresponsibility.

The inadequate American savings the PRC has harped on for years effectively sustained millions of Chinese jobs—jobs Beijing is desperate to keep.[8] In fact, despite its massive 2008 trade surplus, China is looking to boost exports further, relying on foreign consumption for still more help.[9]

On the U.S. side, Chinese purchases of American bonds will support the "pump-priming" designed by the Obama Administration. But American gains from the relationship go beyond that. Chinese exports to the U.S. are led by consumer electronics—computers, phones, and televisions. Clothing and textiles are the other major component.[10] Competition and products from the PRC have yielded lower prices and higher quality for American consumers, developments that are welcome when times are good and more urgent now that household income is stagnant or dropping.

It is a mistake, though, to translate these gains for the U.S. into a belief that China has disproportionate influence over the American economy. In 2007, the PRC's exports to the U.S. were equivalent to 2.3 percent of American GDP; they were 9.1 percent of Chinese GDP.[11] China's holdings stood at 5.3 percent of U.S. public debt securities on the most recent measure and much less than that when private debt is included.[12]

Just as important is the nature of the bilateral economic relationship. Fannie Mae and Freddie Mac do not sell debt to finance U.S. government intervention in the housing market; China cannot

1. "China's Yuan 'Manipulation' an Issue--Geithner," Reuters, January 21, 2009, at *http://www.reuters.com/article/usDollarRpt/idUSN2148652720090121* (January 26, 2009).
2. Derek Scissors, "The Coming U.S.-China Trade Conflict," Heritage Foundation *WebMemo* No. 2172, December 12, 2008, at *http://www.heritage.org/Research/AsiaandthePacific/wm2172.cfm* (January 26, 2009).
3. Sebastian Mallaby, "What OPEC Teaches China," *The Washington Post*, January 25, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/01/23/AR2009012303291.html* (January 26, 2009); Bret Swanson, "Geithner Is Exactly Wrong On China Trade," *The Wall Street Journal*, January 26, 2009, at *http://online.wsj.com/article/SB123293057464414089.html* (January 26, 2009).
4. "FXHistory: Historical Currency Exchange Rates," Oanda.Com, at *http://www.oanda.com/convert/fxhistory* (January 26, 2009).
5. *China Monthly Statistics*, Vol. 12, 2004.
6. This is not the same as manipulation. As with so many of its policies, China's currency policy is dictated by obsession with stability. A relatively minor shift in July 2005 aside, the yuan has not changed since the 1994 devaluation. The stability obsession was very useful to the U.S. during the Asian financial crisis. What has changed since then is primarily U.S. goals for Chinese currency policy, not the policy itself.
7. Joseph J. Schatz, "Geithner Signals Change in Policy on China Currency," Yahoo News, January 22, 2009, at *http://news.yahoo.com/s/cq/20090122/pl_cq_politics/politics3016257_1* (January 26, 2009).
8. "Mood Not Bullish as China Greats Year of the Ox," Google News, January 25, 2009, at *http://www.google.com/hostednews/afp/article/ALeqM5ixfonH0Ud6wKGldX4fHpW1spnJxQ* (January 26, 2009).
9. "More Textile Export Rebates Soon," China Economic Net, November 21, 2008, at *http://en.ce.cn/Industries/Consumen-Industries/200811/21/t20081121_17458415.shtml* (January 26, 2009).
10. U.S. Census Bureau, U.S. International Trade Statistics, see "China (mainland)," at *http://censtats.census.gov/sitc/sitc.shtml* (January 27, 2009).

buy that debt, no matter how many dollars Beijing holds. The same is true of the bonds sold to finance U.S. federal deficit. If Americans choose not to buy as many goods, the PRC cannot sell as many, no matter how high production goes. There are plenty of substitutes for Chinese goods and capital, even if, at higher prices, there is no substitute for the American bond market and consumer.

The U.S. has benefited from Chinese over-saving, and China, from American under-saving. Poor policies on both sides of the Pacific led to excess and the current crisis. But it is inaccurate and potentially dangerous to lay most of this at the feet of the Chinese. Yes, the PRC shares blame for the global imbalance that is now unwinding. Given the size and centrality of the American economy, the problem and the solution start in the U.S. To determine otherwise is to trust, mistakenly, our nation's economic fate to others and risk a trade war in the bargain.

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11. Eugene P. Sesky and Shelly Smith, "Annual Revision of the National Income and Product Accounts," U.S. Department of Commerce, Bureau of Economic Analysis, August 2008, at *http://www.bea.gov/scb/pdf/2008/08%20August/0808_nipa_annrev.pdf* (January 26, 2009); and "China 2007 GDP Growth Revised up to 13%," *China Daily*, January 14, 2009, at *http://www.chinadaily.com.cn/china/2009-01/14/content_7396604.htm* (January 26, 2009), and U.S. Census Bureau, U.S. International Trade Statistics, see: China (mainland), at *http://censtats.census.gov/sitc/sitc.shtml* (January 27, 2009).
12. Wayne M. Morrison, *et al.*, "China's Holdings of U.S. Securities: Implications for the U.S. Economy," Congressional Research Service, January 9, 2008, at *http://fpc.state.gov/documents/organization/99496.pdf* (January 26, 2009).