The Heritage Foundation
LEADERSHIP FOR AMERICA

ISSUE BRIEF

No. 3616 | MAY 29, 2012

China Drowning in Money: What It Means for the U.S.

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Global financial markets are keenly interested in China's short-term economic direction and policy choices. American policy should look farther. If China chooses to try to stimulate its economy in the second half of the year, even if successful, it will only exacerbate a more pressing long-term challenge.

This challenge in part takes the form of too much money. While attention is focused on when the People's Republic of China (PRC) might catch the U.S. in terms of GDP, it has already passed the U.S. on some measures of its monetary base. Such high liquidity typically precedes periods of stagnation or even outright economic contraction. It is one of the surer reasons for anticipating that China's true economic growth might slow sharply, a possibility that has clear implications for American policy.

Moreover, excess Chinese liquidity has already had an impact in the U.S. The two economies are linked by Beijing's chosen balance-of-payments rules, which tie the yuan to the dollar and compel the PRC to hold excess reserves in American bonds. The U.S. has its own money supply management challenges, and communication between the two countries' monetary authorities will be valuable.

Not for All the Money in China. There are many different ways to measure the supply of money. There are also pronounced differences in national monetary systems, which cause natural differences among economies. For a large economy, the PRC is immature financially, so that more capital stays within the banking system. This is a well-recognized long-term problem.[1]

One manifestation of the problem is a comparatively high ratio of broad money M_2 (currency in circulation plus demand and time deposits) to GDP. China is well above the global average on this measure, while a somewhat similar economy in Brazil is well below. Nearly all of the countries that have higher M_2/GDP ratios than China are in Europe, which, in light of recent developments, is not reassuring.[2]

More importantly, the ratio for the PRC is not only high but has been rising steadily. Since the financial crisis, a number of countries have rising liquidity, including the U.S. However, those countries with both high and clearly rising liquidity (Spain, for example) are a small and unhealthy bunch. This is not good company for China to be keeping.

The U.S. is only one point of comparison, but it is an instructive one. In 1998, China's M_2 was 70 percent smaller than America's. In 2011, it was 40 percent larger. While Chinese GDP expanded greatly in that period, it was still only half of American GDP at the end of last year. Yet the PRC had $3.8 trillion more in broad money supply sloshing around.

Measurements of leveraging show roughly similar problems. China's dependence on bank loans for financing intensified with the lending explosion in 2009. In 1998, loan volume was 102 percent of GDP. By 2008, it had only inched higher to 106 percent of GDP. Just three years later, though, it had jumped to 123 percent of GDP. More comprehensive measures of credit show still higher figures and steeper climbs.[3]

What Happens Next? There is plenty of discussion at present about short-term weakness in the Chinese

This paper, in its entirety, can be found at **http://report.heritage.org/ib3616**

Produced by the Asian Studies Center

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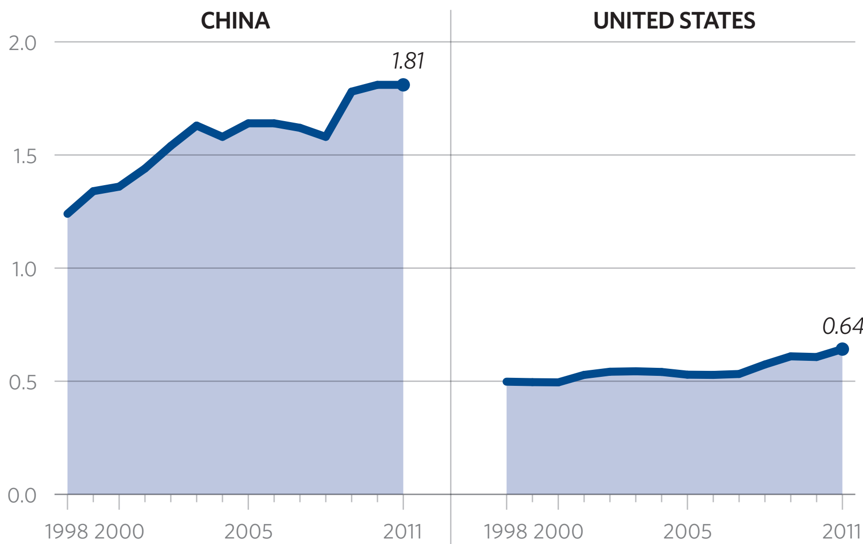
CHART 1

Comparing Money Supplies

RATIO OF "BROAD MONEY" TO GDP, FOR CHINA AND THE U.S.



Sources: China Monthly Statistics, Vol. 1, 1999–Vol. 1, 2012, National Bureau of Statistics, Beijing; Board of Governors of the Federal Reserve System, Economic Research and Data, "Money Stock Measures," May 17, 2012, http://www.federalreserve.gov/datadownload/Choose.aspx?rel=H.6 (accessed May 23, 2012); U.S. Department of Commerce, Bureau of Economic Analysis, National Economic Accounts, "Gross Domestic Product (GDP)," May 15, 2012, http://www.bea.gov/national/index.htm#gdp (accessed May 23, 2012).

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economy and whether additional stimulus is the right response. The longer term is clear: On its present policy path, the effective stimulus Beijing can apply through monetary policy will continue to decline.

At the high levels of liquidity that have now been reached, further leveraging has and will continue to become increasingly ineffective. More and more money must be employed to get the same results. Barring a major policy misstep, there is no true crisis imminent. However, a crisis must loom as a possibility at some point.

This leaves Beijing with unpleasant choices. More monetary stimulus will have only a limited impact now at the cost of digging deeper into a hole that China must eventually climb out of. Whether or not further short-term stimulus is chosen, the PRC must eventually de-leverage to some extent. This will exert downward pressure on growth for some time. After years where growth has been inflated by a flood of new money, this signifies instability, and the Communist Party does not like instability.

How liquidity is drained, however, could matter a great deal. Broad money should at least stabilize relative to GDP, and total credit should slow relative to GDP. It would be greatly preferable if, at the same time, bank lending were to become less important. This could occur with financial reform. The PRC should have more commercialized banks that are more circumspect about lending under the wrong conditions. It should have more financial options so that banking is less important relative to bonds, stocks, futures, and other financial outlets.

Financial reform is not only painful; it takes time. Interest rate liberalization, de-control of financial markets (with attendant risk), and partial privatization in banking cannot be done overnight. Beijing has a bit of time, since there is no impending crisis, but genuine reform should start as soon as possible. If it begins quickly, the payoff from reform can more than offset the discomfort from the inevitable deleveraging. The PRC's financial system can shift from a source of instability to a source of efficiency.

American Involvement. Like it or not, the U.S. is already involved in the Chinese liquidity problem. Some

1. Ronald I. McKinnon, "The Case Against Exchange Rate Flexibility for China: The Plight of an Immature International Creditor," East Asia Forum, September 2010, http://www.eastasiaforum.org/wp-content/uploads/2010/10/China-Finance-2-The-Case-Against-Exchange-Rate-Flexibility-for-China2.pdf (accessed May 22, 2012).
2. The World Bank, "Money and Quasi Money (M2) (Current LCU)," http://data.worldbank.org/indicator/FM.LBL.MQMY.CN (accessed May 22, 2012).
3. Derek Scissors, "China's Economy: Something Is Not Right in Beijing," Heritage Foundation *WebMemo* No. 2775, January 25, 2010, http://www.heritage.org/research/reports/2010/01/chinas-economy-something-is-not-right-in-beijing; China Monthly Statistics, National Bureau of Statistics, Beijing, http://www.stats.gov.cn/english/statisticaldata/ (accessed May 22, 2012); and Tom Orlik, "Deleveraging China," *The Wall Street Journal*, May 17, 2012, http://online.wsj.com/article/SB10001424052702303360504577411151135639534.html (accessed May 22, 2012).

portion of excess Chinese liquidity inevitably spills into the U.S.—and more than anywhere else, because the yuan is tied to the dollar. Most famously, this was part of the feedback loop that contributed to the recent financial crisis. It has continued since, with Chinese money entering the U.S. in various ways.[4]

But, as it was before the financial crisis, Chinese liquidity overflow into the U.S. remains only part of the loop. Though American money supply is now smaller, the U.S. economy is still much bigger, and the dollar is the world's reserve currency. Extra American liquidity, whether due to low interest rates in the middle of the last decade or quantitative easing more recently, spills over onto the rest of the globe.

When it finally becomes willing to deal with its own monetary problems, Beijing will therefore cast a nervous eye to the Federal Reserve. To a lesser extent, the Fed should do the same with regard to the People's Bank. The U.S. should:

- **Continue and enhance information exchange with China on monetary policy.** Countries make their own monetary choices, but transparent and timely communication helps make for better policy.
- **Plan for notable economic change in the PRC in the medium term.** Beijing could adopt financial reform and become much more efficient, or it might refuse and see true growth slow considerably.
- **Intensify bilateral and Asian regional trade and investment liberalization**, such as the Trans-Pacific Partnership, to help protect friends and allies against a possible Chinese slump.

Tightening the Taps Together?

China and the U.S. face the same long-term challenge to unwind money growth. The two challenges are connected, though the PRC's is clearly more daunting. China must act or lose monetary policy as a tool, and American policymakers should be aware of the stakes.

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4. Maurice Obstfeld and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes," paper for the Federal Reserve Bank of San Francisco Asia Economic Policy Conference, November 2009, http://www.imf.org/external/np/res/seminars/2010/paris/pdf/obstfeld.pdf (accessed May 22, 2012); and Derek Scissors, "Chinese Outward Investment: More Opportunity Than Danger," Heritage Foundation *Backgrounder* No. 2579, July 13, 2011, http://www.heritage.org/research/reports/2011/07/chinese-outward-investment-more-opportunity-than-danger.