

August 22, 2006

Testimony of
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to
the U.S.-China Economic and Security Review Commission
on

The Macroeconomic Impact of Chinese Financial Policies on the United States

I thank the Members of the U.S.-China Economic and Security Commission for providing me with the opportunity to testify.

In evaluating the impact of Chinese policies on the U.S. and world economies, I will focus first on the questions posed by the Commission on the sustainability of the present equilibrium and then on the impact of Chinese policies. Of particular importance to the focus of this panel are the low level of national saving in the United States, and the overly expansionary stance of monetary policy in China, a policy which is associated with a weak exchange value of the Chinese currency.

Without getting too far away from China, it is useful to note that the overall U.S. trade deficit mainly reflects low national saving in the United States and a reasonably strong level of investment relative to GDP. The trade deficit is nearly equal to the current account deficit, which in turn equals the excess of U.S. national investment over saving. In considering the potential consequences of the U.S. external imbalance, it is vital to focus on the underlying cause, which is the lack of saving in the United States. One view of the current account deficit—and there are several—is that it represents the extent to

which inflows of foreign capital are being used to finance U.S. investment. Another is that it represents an accumulation of assets by foreigners as they provide the United States with goods in exchange for U.S. assets. If this is worrisome, the appropriate U.S. policies aimed at facilitating adjustment of the external imbalance would be to focus on measures with the potential to boost national saving, including both public and private saving. The key challenge in terms of the public sector balance sheet is to address the long-term fiscal imbalances arising from entitlement programs. On the household side, economic research suggests that reforms to eliminate the remaining bias against saving in our tax code could boost overall personal saving. Measures that lead to increased national saving would contribute to capital accumulation and thereby boost economic growth and job creation. These are actions that would be useful for the United States to take for our own sake.

The Chinese economy is growing strongly at about 10 percent per year, but this appears to be marked by overinvestment in export-oriented sectors and a mounting problem in some parts of the financial system. Excess liquidity stemming from strong growth of bank credit will at some point give rise to inflationary pressures (if anything, it is remarkable that inflation has been contained to date). For the time being, the Chinese government has been able to stem these pressures through administrative means such as increased reserve holdings and ad hoc interest rate increases. It would be much simpler, however, for China to allow its currency to appreciate as part of a broad tightening of monetary policy (in principle, Chinese capital controls should allow the authorities to have independent monetary and exchange rate policies, but these controls seem to be only partially effective). An appreciation of the Yuan would make it difficult for some export-

oriented enterprises in China to prosper in international markets, but the appropriate and useful response to this competitive pressure would be for such firms to reorient their production to the domestic rather than export market (or for the firms to otherwise change their business plans). With a stronger currency, growth could remain strong in China as lower investment and higher imports are offset by much stronger consumption. This would contribute to a better quality of life for Chinese families, who would be able to enjoy some of the output of their labor rather than seeing it put into containers destined for other countries.

A further challenge for China is to develop a social safety net to replace the system that has eroded in the course of China's move away from central planning. Having an appropriate system for old-age retirement security, protection against disability, and a better-functioning health insurance mechanism would likely lead to a decline in the huge amount of precautionary saving now put away by Chinese families. If China lives up to its international obligations to open its markets and protect foreign intellectual property rights, increased consumption by Chinese families would give rise to increased imports as well. This will help to rebalance both the Chinese and U.S. economies, as exports replace consumption for supporting U.S. GDP growth.

It would thus be in the long-term best interest of both China and the United States for China to adjust its monetary and exchange rate policy. At the same time, we should be aware that China's expansionary monetary policy and correspondingly weak currency has a variety of impacts on the United States. Some families face adverse effects as their jobs come under competitive pressure from import competition. On the other hand, China's action in preventing the Yuan from strengthening much against the dollar is beneficial on

the whole to low-income households in the United States, because poor families see their budgets go further as a result of the availability of low-priced products. Chinese monetary policy also contributes to some extent to lower borrowing costs for the federal government and contributes as well to lower interest rates for U.S. consumers, homeowners, and firms.

It appears that the Chinese are keeping their currency weak because they are scared of having growth slow down and as a result not generate enough jobs for the hundreds of millions of Chinese who are in the process of migrating from farms to urban factories. In essence, the Chinese seem to be spending on insurance against social unrest. They are buying an unnecessary insurance policy since they could grow just as well with an economy oriented toward providing Chinese families with high-quality low-cost products rather than providing these to American families.

China is also paying a lot for this insurance. If China has pegged its currency about 25 percent too weak against the dollar, this means that China is paying 25 percent too much for the bonds it purchases from the U.S. Treasury, amounting to a gift of \$50 billion or more every year from the people of China to the citizens of the United States. Chinese bond purchases keep U.S. interest rates lower than otherwise. It's hard to know just how much, since if China did not buy U.S. Treasury bonds then someone else would, but the Treasury would have to pay a higher interest rate. One estimate from the Federal Reserve is that all foreign purchases of U.S. Treasuries, of which China's are an important component, lower U.S. borrowing costs by 100 to 150 basis points (1 to 1.5 percentage points). The artificially weak Yuan further implies that China is selling goods

to the United States for lower prices than would be the case otherwise, and this is a gift as well to U.S. firms, families, and shareholders from the hard working families of China.

It would be better for China to allow its exchange rate to be flexible. What they should really do is have an economy that is more balanced. Speaking loosely, this would mean that Chinese factories would make things for Chinese families rather than for American families, and China would buy more goods and services from us than vice versa. Realistically, I would expect China to buy services rather than goods from the United States – but in this I would include that they should pay for movies and software from the United States rather than stealing them. Having growth in China driven by domestic consumption and growth in the United States driven by exports in turn would allow the United States to save more.

Some people worry that Chinese holdings of U.S. Treasury bonds gives China leverage over U.S. economic policies, perhaps by changing the composition of their international reserve holdings. Our debt is their asset, and any move to spark a sell off of dollar assets—whether intentional or accidental—would hurt China by wiping out a large portion of Chinese wealth. Even a gradual exchange rate adjustment will be painful for China, since a stronger Yuan will give China a huge capital loss as the value of their Treasury bonds holdings falls by 25 percent or more. This massive loss is baked into the cake, since China has already overpaid for its assets. With total holdings of about one trillion dollars, China will take a loss of \$250 billion. From the perspective of Chinese families, China is already in the hole and should just stop digging by allowing its exchange rate to adjust and no longer overpaying for U.S. assets.

An important concern is that this gift could be contributing to a future problem of a “disorderly adjustment.” Under such a scenario, if foreign investors balk at accumulating further dollar assets then U.S. interest rates could rise and the exchange value of the dollar could weaken. This could spur inflation and lead to a monetary policy response that further increases interest rates. In turn, this could have an adverse impact on investment, growth, and job creation. This is a possibility. The initial step, however, involves global investors redirecting their savings from dollar (and U.S.) assets to investments in other countries. Growth in Europe and Japan has rebounded somewhat, with Japan in particular seeming to finally be entering a period of sustainable expansion. And yet, U.S. investments seem likely to remain attractive, not least because the United States remains the global leader in innovation and economic dynamism. One can construct a scenario in which global imbalances that have developed in part as the result of Chinese policy unravel and cause an economic downdraft here and around the world. But this does not seem likely.

Even so, policymakers should work to avoid problems before they become crises. The policies that should be undertaken by each country, including the United States, China, and other nations, are the policies each country should take in its own interest. As a result, there seems to me to be modest value for a meeting to sort out these problems along the lines of a proposal for a Plaza-Louvre-like meeting or agreement. If such a meeting could provide political space in which nations could address their underlying problems, then perhaps a global mechanism would be useful. I am not sure, however, that a commitment on the part of European nations to remove the burdensome labor market regulations that hobble their growth or a Chinese commitment to allow a floating

exchange rate would have a meaningful impact in leading the United States to address our long-term fiscal situation. We will address our fiscal issues, but for our own sake. In the meantime, it would be useful to continue to address global imbalances through existing mechanisms, notably the International Monetary Fund. The United States could also usefully provide technical assistance to help China develop a social safety net and improve the stability of its financial sector.

Thank you for your attention.