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"China's Role in the Origins of and Responses to the Global Recession"

The Financial Crisis and the Sino-American Economic Link

Addressing the effect of the current economic crisis on the U.S.-China economic relationship presumes an understanding of the crisis and the relationship. This is plainly a matter for debate but, for the purposes of my testimony, the single biggest contributor to the crisis is an overly loose American monetary policy which began in late 2002. This policy was exacerbated by federal government-sponsored distortion in housing and flawed regulation of the credit system.

As is well-known to the commission, there has been a Chinese contribution to loose American monetary policy. The nonconvertibility of the yuan and the singular global stature of our bond market combine to effectively force the recycling of the surplus dollars the PRC earns through trade with the U.S.

This, however, is not a particularly good explanation of the time pattern of American interest rates. Most striking, Chinese purchases of U.S. Treasury bonds barely budged (and their purchases of agency debt slowed sharply) from June 2007 to June 2008 but the federal funds rate plunged. While the data are too limited to be conclusive, it is in any case the responsibility of U.S. monetary and fiscal decision-makers to adopt correct policies, especially when Chinese contributions to liquidity are entirely transparent. That conclusion leaves the understanding of the bilateral economic relationship itself.

The Chinese Side of the Relationship

Whatever its sources, loose American monetary policy has had global repercussions. One effect that has been largely missed and is germane to this hearing is our underwriting of China's economic acceleration from late 2002 to late 2007. In late 2002, the then-new administration of Hu Jintao and Wen Jiabao embarked upon a traditional pattern for incoming Chinese leaders: buying political loyalty through faster economic growth. Credit was greatly loosened, triggering a surge in investment, production, and export.

Had this loosening of credit occurred two years earlier, when domestic retail prices were falling outright and foreign demand was unsteady, the result for the PRC would have been crushing deflation. Loose U.S. monetary policy, though, stimulated not only American but global demand. This permitted China to export excess production and accumulate foreign exchange to more easily acquire mineral resources to sustain the excess production. Money earned from exports enabled skyrocketing deposits by firms, joining those by individuals, and bolstered the financial system against the outpouring of loaned funds (see Table 1).

And so a virtuous, if temporary, cycle was created. Apparently believing that they had found a new economic approach, Chinese decision-makers eschewed further market reform beginning around 2004.[1] Many observers implicitly endorsed that decision, finding the "Chinese way" to be superior. China's baseline growth had stemmed from demographics, intense resource exploitation, and the efficiency gains from market reform introduced voluntarily for much of the 1990s, then introduced through the concessions made to win WTO membership. The additional gains seen from 2003-2007 were due to artificial stimulus made temporarily more powerful by money illusion originating in the U.S.

That is to say, the recent phase of the Chinese economic miracle suffered from the same conceit plaguing many workers, investors, and policy-makers around the globe. The world was not necessarily working harder or investing smarter or making better choices; instead, loose credit merely made it seem so, just as tight credit now makes everyone seem foolish. The PRC's complaint against the U.S. for causing the financial crisis is partly accurate. Among the things left unsaid is that, in the same way, we are also significantly responsible for China's boom prior to the crunch.

This clarification of the sources of China's recent expansion understates the challenge Beijing now faces. It is likely to be considerably more difficult for the balance of payment surplus countries, such as the PRC, to adjust to the financial crunch than it will be for deficit countries such as the U.S. The simplified logic is that extravagant spenders will save when times are difficult but extravagant savers are unlikely to spend, which is necessary for their national economies.[2] The Commission should not be fooled by the wonderful economic statistics Beijing will continue to announce. China's success earlier this decade was somewhat over-interpreted and the obstacles before it are being widely understated.

The American Side of the Relationship

One area of concern in the U.S. is Chinese financial influence. As noted, Chinese investment is largely involuntary, a function of having a great deal of money and no place else to put it. This refines the usual analogy of banker and customer to one where the banker has a choice of "lending" to one particular customer for the better part of her business, or crafting an exceptionally large mattress. The influence is mutual.

Who needs the other more varies with American and international financial conditions. The more money the U.S. borrows, the more the American economy needs the PRC. The more desirable Treasury bonds are, the more China needs us. The U.S. is planning to run a federal deficit of over $1 trillion but there has been a flight to quality and American

[1] See, Derek Scissors, Ph.D., "U.S.—China Economic Dialogue: In Need of Tough Love," Heritage Foundation WebMemo No. 2200, October 21, 2008, at *http://www.heritage.org/Research/AsiaandthePacific/bg2200.cfm*.

[2] I note my colleague Michael Pettis' intellectual leadership on this point without binding him to my version.

Treasury bonds are highly desired. There is balance on this score. The PRC can exercise little or no leverage over American policy by virtue of its purchase of our bonds.

There is future danger in the possibility that we will run sustained, gigantic deficits. The longer these last, the more likely it is that U.S. treasuries will become relatively less attractive, thereby tipping the balance of influence toward China. The U.S. could come to need Chinese purchases more than the PRC needs American bonds, yet another argument to control the federal budget.

Beyond bonds, Chinese investment in the short term will be minor. Failed investments by SAFE and others—for example SAFE's losses in its fund with TPG and CIC's painful investment in Blackstone—have made Beijing naturally cautious. Even when asset prices begin to recover, there are multiple reasons why Chinese investment will remain guarded, including the fact that, as long as it runs large trade surpluses, the PRC has no pressing need to generate additional foreign currency through investment.

The same motives will push China's non-bond investment away from the financial sector where it was concentrated prior to the crisis.[3] If permitted, SAFE, CIC, and Chinese state financials and corporates will likely seek control of various kinds of assets plentiful in the U.S. but in short supply in the PRC. Such assets range from physical resources such as farmland to equity stakes in business accounting firms.

Another area of concern frequently raised in Congress is the bilateral deficit. The deficit is often blamed on manipulation of the yuan and sometimes attributed to China's failure to live up to pledges made at WTO accession. These are topics worth discussing but they can obscure important facts.

From China's WTO accession at the end of 2001 thru 2007, American exports to the PRC more than tripled, slightly outpacing imports from the PRC. The deficit rose because the base established before WTO accession featured much larger American imports from China than exports to the PRC. That base can be traced, in turn, to the Asian financial crisis. Chinese exporters switched away from failing regional markets and there was a third wave of FDI from East Asia, seeking China as a platform to export to the U.S. At that time, Washington praised Beijing for holding the yuan steady when it might have been overvalued. The origins of the deficit lie neither with an undervalued yuan or violation of WTO pledges.

Looking forward, the present crisis is almost surely going to cut into both American exports and imports. However, the effect on the deficit may be limited: In November it fell only 5 percent on-year. It is too early to be confident but a retreat along the path broken over the past 10 years is possible: American exports and imports decline at a similar rate and the deficit falls noticeably because imports are much larger. It is also

[3]This observation is derived from a new and ongoing Heritage Foundation dataset on China's non-bond investment around the world starting in 2005. See, Derek Scissors, Ph.D., "Chinese Foreign Investment: Insist on Transparency," Heritage Foundation *Backgrounder* No. 2237, February 4, 2009, at *http://www.heritage.org/research/asiaandthepacific/bg2237.cfm*.

true, however, that Chinese firms have been competitive in difficult times and could capture additional market share.

The deficit is often said to represent jobs lost due to bilateral trade. Any job loss, of course, must be weighed against the lower prices available to American consumers, the benefits of competition for our economy, and the role an open American market plays with regard to U.S. global leadership. It is worth noting that consumer electronics, clothing, toys, and furniture are the leading American imports from China. Lower prices on these goods may disproportionately benefit those with average or below-average income (see Table 2).

Also, it is fairly clear that it is not truly China we might be losing jobs to. The majority of exports from the PRC are manufactured by foreign-funded ventures. U.S. investment into China has been declining since 2002, while the bilateral surplus has soared, and accounted for only about 7 percent of official FDI through 2008. This compares to the U.S. receiving close to 18 percent of China's exports on official data and 24 percent on American data.

What has happened is foreign investors other than the U.S. have located factories in the PRC to serve the American market. If production in China became less competitive for any reason, these investors would simply relocate to Vietnam, Mexico, and elsewhere.

Solutions

It is not the case that the U.S.-China economic relationship must change for the crisis to be resolved. The Chinese economy is not big enough to have that kind of impact on the American economy. Nonetheless, the ideal solution to the crisis would include more open trans-Pacific trade and investment, so as not to repeat the creation of harmful imbalances on both sides.[4]

The tasks for the U.S. are largely internal: better monetary and fiscal policy. In addition, we must fight the tendency to use trade and investment imbalances and China's ambivalence toward liberalization as excuses for protectionism.

China faces more difficult challenges. The PRC must encourage true consumer spending, not "domestic demand" which turns out to be lending for investment, resource use, production, and export. It would be helpful in this regard if the central government would back up words about health insurance and pensions by giving these concerns equal status with economic expansion for job creation. This should occur as demographic pressure eases by the middle of next decade, but is highly unlikely as a crisis response.

The other dimension of the challenge is one China has avoided throughout the reform era and is especially unpopular at the moment: liberalizing the financial system. To make

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[4] I consider the integration of China's response to the crisis with that of other countries and international institutions to be a red herring. No nation with a degree of economic autonomy, including the U.S., gives much weight to international coordination in a true crisis.

borrowing easier for the government and state firms, interest rates are strictly determined and continually depressed by the People's Bank. This robs savers of wealth. The need to shelter domestic banks is also used to justify the closed capital account, which traps consumer, and some enterprise, savings. This helps state banks lend without regard to commercial return, a colossal subsidy for the state firms to which these banks almost exclusively lend.

Some of these subsidized firms, of course, are exporters. The money they earn overseas cannot be used to create pension funds or otherwise aid Chinese consumers because the yuan is not convertible, another aspect of the controlled financial system. So China saves too much and runs up huge trade surpluses and foreign exchange reserves, which it then cannot use. In this manner, Beijing both contributes to global imbalances and denies its people some fruits of a free market. Financial liberalization in the PRC will certainly not solve the crisis but it will make for a better Chinese, better American, and better global economy.

Table 1: Chronicling The (Official) Boom (% change)

Indicator	2003	2004	2005	2006	2007
Bank loans	+21.1	+14.5	+9.8	+15.7	+16.2
Internal investment	+26.7	+25.8	+25.7	+24.0	+24.8
Trade surplus	-16.1	+25.5	+218	+74.2	+47.4
Corporate Savings	+20.8	+16.8	+13.5	+17.7	+22.5
Outward investment	+41.1	+93.0	+124	+71.5	+25.6

Sources:

China Monthly Statistics,
Statistical Bulletin of China's Outward Foreign Direct Investment

Table 2:

Top 10 Imports From China, January-November 2008 ($ billions)

SITC code	Description	Amount
752,759	Computers and parts	35.8
764	Cell phones and the like	29.8
894	Toys and games	25.6
761	TV's	16.0
821	Furniture	14.1
851	Shoes	13.5
751	Other office machines	7.9
845	General clothing	7.8
842	Some women's clothing	6.9
775	Household equipment	6.2

Source: http://censtats.census.gov/cgi-bin/sitc/sitcCty.pl

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