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From: sbwhoeop
Sent: Tuesday, November 17, 2009 9:41 AM
To: H
Subject: FYI: This CFR analysis clears away fundamental misperceptions on US-China. Sid

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Council on Foreign Relations

Expert Brief

The U.S.-China Economic Relationship: Separating Facts from Myths

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November 16, 2009

http://www.cfr.org/publication/20757/uschina_economic_relationship.html?breadcrumb=%2Fregion%2F271%2Fchina

Many myths surround the economic relationship between the United States and China. Four, in particular, stand out, and it is important to identify them as myths to avoid misunderstandings that could adversely influence policy decisions. The fact that China has become the largest foreign holder of U.S. government securities is taken as indicating that the United States is heavily dependent on China to finance its budget deficits. Similarly, since China is a major source for U.S. imports, U.S. consumers are seen as dependent on cheap Chinese goods. In addition, the Chinese authorities have emphasized that they strongly resist external pressures to try to influence policy decisions and that economic instability in China is bad, with adverse implications for the rest of the world.

Taken together, these four myths could lead to the conclusion that China should not be pushed hard by the United States (or other major countries) to more quickly change its policies, especially its exchange rate policy, to facilitate the rebalancing of its economy. But such a conclusion would be a major mistake, and that is why during his trip to Asia, President Barack Obama needs to dispel these myths and bring pressure to bear for faster economic policy changes in China. This would be in keeping with the objectives for dealing with global imbalances laid out by the G-20 summit in Pittsburgh in September 2009.

Myth No. 1: Washington has limited leverage because China is the main "banker" for the United States

China holds a large amount of U.S. government securities. Of China's $2.3 trillion in official reserves, it is estimated that 70 percent is held in U.S. dollar assets. China is a big customer for U.S. debt, but it is not America's banker. Nor is the United States dependent on China to finance its budget deficits. If China elects not to buy U.S. Treasuries, there are other willing public and private sector buyers, as indicated by the strong demand for these securities worldwide. Although the U.S. government might have to pay higher interest rates as an incentive to get other investors to buy Treasuries in the event that the Chinese reduce their demand, the increase in interest rates would likely be small.

Major consequences from a decision by China to reduce its purchases of U.S. Treasury securities would depend on the reason behind the decision. It would be in China's best interest (and beneficial for the rest of the world as well) if China reduced its purchases of U.S. Treasuries because it decided to stop heavily managing its exchange rate and allow greater flexibility in the currency's movements. This is an important policy change that is required if China is going to rebalance its economy and be able to sustain rapid growth.

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If instead China continues to heavily manage its exchange rate, it will build up large additional amounts of official reserves. If it decides to hold less of these additional reserves in U.S. Treasury securities, then China will increase its purchases of assets denominated in other currencies, with euro-denominated securities being the most likely alternative. In these circumstances, China would continue to intervene in its exchange market, with the central bank buying U.S. dollars for Chinese renminbi and then selling dollars for euro to acquire European assets. The result would be an appreciation of the euro. Consequently, countries in Europe, not the United States, would probably be most affected by China's move because the negative impact of euro appreciation on European economic activity would likely far outweigh the effects on the United States of smaller Chinese purchases of Treasuries.

Alternatively, China could choose to start dumping its stock of U.S. securities. The result would be appreciation of other major currencies (depending on where China would decide to park its reserve assets); upward pressure on U.S. interest rates; and the possibility of financial market disruptions if China dumped its U.S. dollar assets rapidly. However, the U.S. Federal Reserve could limit the rise in U.S. interest rates and would be able to ensure adequate liquidity to prevent market disruptions. But a decision to dump Treasuries would have a large effect on China itself. The country would incur a substantial capital loss on its reserve assets. The Chinese authorities are deeply concerned about such a loss, and are very unlikely to decide to dump U.S. assets. In fact, the discussion initiated by China regarding the need for an alternative official reserve asset is motivated by its concerns about potential losses on its U.S. dollar holdings.

Myth No. 2: The United States is heavily dependent on cheap Chinese goods

This is not really true. Only roughly 15 percent of U.S. imports come from China. Moreover, all of the basic types of manufactured consumer goods that China exports to the United States (clothing, textiles, footwear, toys, small appliances, etc.) can be imported from other countries or could be produced domestically. The prices for goods that could substitute for products from China would be higher, but the difference in costs would be relatively small. Competition among producers has become fiercer, and as a result cost differentials between goods from China and other suppliers are narrowing.

Dependence actually runs the other way. China is highly dependent on U.S. demand for its products. Economic growth in China is heavily dependent on exports. Although China has been able to achieve its 8 percent GDP growth target in 2009 owing to the stimulus to domestic demand provided by government policy actions, the country will struggle to meet this objective in 2010 and succeeding years if demand for its exports in the United States does not pick up.

Myth No. 3: External pressure on China for policy changes is counterproductive.

The Chinese authorities stress that in the face of external pressure, they tend to strongly resist economic policy changes. The Chinese have in particular used this argument to try to fend off pressures for appreciation of the exchange rate. While no country wants to appear to be weak and susceptible to external pressure, the truth is that, if there is no pressure, there is less incentive to change policy. This is especially true in China, where the authorities are wedded to the status quo because of past success and inclined to make only gradual changes to economic policies. Recent developments in China's exchange rate illustrate this point. In the absence of external pressure since August 2008, China has reverted to fixing its exchange rate relative to the U.S. dollar.

Without a hard push from the United States on a bilateral and multilateral basis, changes in China's policies are likely to be delayed, and that is not in the best interest of the United States and the rest of the world.

Myth No. 4: Instability is bad for China

Chinese authorities also have suggested that instability in China is bad for the rest of the world because of adverse effects on China's growth rate. But instability (or the fear of instability) has played a big role in initiating economic policy changes in China. For example, concern about instability arising from the growing gap between urban and rural incomes has been a major factor behind new initiatives to develop China's interior (such as the Develop the West program) and to improve conditions and opportunities for the rural population (including breaking down restrictions and discriminatory treatment of migrant workers). Hence, for China, instability is not necessarily bad, but it is a problem for the authorities. Instability in China also is not necessarily bad for the rest of the world because of its effect on China's growth. Although China accounts for a significant portion of world GDP growth, the country does not generate much demand for products from other countries given China's large trade and current account surpluses. Some countries in Asia and commodity producers may be benefiting from China's strong growth, but overall, it is not providing much stimulus for the world economy as a whole, so slower growth in China will have little effect on economic activity in the rest of the world.

It is important for President Obama to separate fact from myth in his economic policy discussions with the Chinese authorities during this trip to Asia to build a sounder relationship. The president should not shy away from pushing the Chinese hard on economic reform and rebalancing of China's economy, but this should be done in his private discussions with China's senior leaders. Multilateral discussions, such as those in the context of the G-20 process, are a much more effective forum for the United States to take a public stance on China's economic policies jointly with other major economies.

Without a hard push from the United States on a bilateral and multilateral basis, changes in China's policies are likely to be delayed, and that is not in the best interest of the United States and the rest of the world. It also is not in the best interest of China, because without a shift away from heavy dependence on investment and exports to drive growth toward greater reliance on consumption, China will not be able to sustain rapid economic growth and development. Getting China to fully realize this and to act more quickly than the authorities are inclined to do is a considerable task for the United States and other major economies.