Effects of the Financial Crisis on The U.S.-China Economic Relationship

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The U.S. and China are two of the dominant economies in the world today and the nature of their relationship has far-reaching implications for the smooth functioning of the global trade and financial systems. These two economies are becoming increasingly integrated with each other through the flows of goods, financial capital, and people. These rising linkages of course now stretch far beyond just trade and finance, to a variety of geopolitical and global security issues. Getting this relationship right is therefore of considerable importance.

The global financial crisis has brought this relationship under the spotlight of international attention. Indeed, the United States and China together epitomize the sources and dangers of global macroeconomic imbalances. U.S. regulatory and macroeconomic policies may well bear a lion's share of the blame for the current crisis. But there is a deep irony in the fact that Chinese virtue—its high national saving rate—and its policy of tightly managing the external value of its currency abetted U.S. profligacy by providing cheap goods and cheap financing for those goods, setting the stage for a cataclysmic crisis rather than a bubble. The consequences of those policies are now rebounding on the Chinese economy itself.

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Paradoxically, the crisis is likely to intensify the embrace between the two economies. In the short run, China needs export growth in order to maintain job growth and preserve social stability. As China continues to run current account surpluses by exporting to the United States and other advanced country markets, it has little alternative to buying U.S. Treasuries with the reserves it accumulates while managing its exchange rate. The United States needs willing buyers for the Treasuries issued to finance its budget deficit, which is certain to increase due to bailout and fiscal stimulus operations.

There are certain unhealthy facets of this relationship that have generated tensions between the two economies, with each of the partners seeing the other as benefiting disproportionately. Indeed, these tensions are likely to intensify at this time of worldwide economic distress, with financial markets and economic activity around the world crumbling and economies increasingly hunkering down to protect and insulate themselves as the aftershocks of the crisis reverberate around the globe.

On the economic front, China's exchange rate policy has become a flashpoint for these tensions between the two countries. With the U.S. trade deficit and, in particular, the bilateral trade deficit with China swelling in recent years, China's tightly managed exchange rate regime has come under increasing scrutiny. China's rising overall trade surplus and its rapid accumulation of foreign exchange reserves have revived accusations of currency manipulation. There have been calls by U.S. legislators for imposing large tariffs on U.S. imports from China or taking other retaliatory measures if there isn't rapid progress on exchange rate reform. Meanwhile, the U.S. is falling prey to its own protectionist tendencies. The "Buy American" clause in the stimulus bill, which will impact imports from China and other emerging market countries, could be a harbinger of rising trade tensions. Indeed, China responded in June 2009 by putting in place some "Buy China" measures in its stimulus package.

A confrontational approach and a rattling of sabers by both sides will almost certainly be counterproductive. This would poison the U.S.-China relationship in a manner that could have deleterious long-term consequences on many fronts. Furthermore, this approach is unlikely to have a large or lasting impact on problems such as the U.S. trade deficit or imbalances in the Chinese economy, and could make matters worse for everyone by creating instability in the global economy.

There is a great deal of commonality of economic interests between the two countries, and it is these shared interests that should be the basis for a mutually beneficial economic relationship. In this article, I will lay out the key facets of this complicated bilateral relationship, present my prognosis for how this relationship is likely to evolve, and then discuss how I believe progress could be made in terms of finding common ground between the two economies.

Trade and Financial Linkages between the United States and China

Trade between the two economies has continued to increase in volume, and the United States remains one of China's major export markets. Chinese exports to the United States rose from $100 billion in 2000 to $338 billion in 2008, while imports rose from $16 billion to $71 billion. Interestingly, however, the share of China's exports going to the United States has actually declined over time, from about 22 percent in 2000 to 19 percent in 2008, roughly the same share as that of the European Union.[1] China's bilateral trade surplus with the United States has risen from about $84 billion in 2000 to nearly $266 billion in 2008 (about 1.9 percent of U.S. GDP).

Financial flows between the two economies have increased but have also become more lopsided over time, with bilateral foreign direct investment (FDI) flows from the United States to China declining from $5.4 billion in 2002 to less than $3 billion in 2008 (this accounts for only about 3 percent of China's gross FDI inflows). FDI constitutes the principal category of inflows into China as many other types of private capital flows, especially portfolio equity investment, have been restricted until recently (many of these restrictions are now gradually being lifted).

In sharp contrast to declining FDI flows from the United States to China, official flows from China to the United States have surged in recent years. This largely reflects Chinese central bank purchases of U.S. Treasury bonds and, until the middle of 2008, agency bonds (including those of Fannie Mae and Freddie Mac). Although precise

[1]These numbers are based on the IMF's Direction of Trade Statistics. When one considers combined trade volumes for Mainland China and Hong Kong, the United States accounted for about 23 percent of total exports in 2008, down from about 30 percent in 2000.

numbers are difficult to come by, estimates based on the U.S. Treasury's International Capital (TIC) data suggest that Chinese holdings of U.S. Treasury securities amounted to about $700 billion at the end of 2008.[2] During 2008, about half of China's total reserve accumulation of $400 billion went toward net purchases of U.S. Treasury bills and bonds.

What happens to the size and nature of the linkages between the U. S. and Chinese economies will depend on the depth and length of the downturn. It will also be influenced by the nature of the measures taken by these economies to pull themselves out of the slump. Above all, however, there is one issue that seems to dominate the bilateral relationship and color various aspects of their engagement, and will continue to do so in the near future.

The Exchange Rate Issue

Much of the discussion about the U.S.-China economic relationship tends to get framed in terms of the currency issue and the bilateral trade balance between the two countries. China is accused of using protectionist policies by maintaining an undervalued exchange rate to boost its competitive advantage in international markets. The fact that China has allowed its exchange rate to appreciate by about 21 percent relative to the U.S. dollar since July 2005 takes some of the wind out of this argument. Of course, the fact that China continued to accumulate foreign exchange reserves at a rapid rate even after mid-2005 indicates continued intervention by China's central bank in the foreign exchange market.

Senior IMF officials have noted that the renminbi (also known as the yuan) remains substantially undervalued, a point underscored by the fact that the renminbi's appreciation relative to the U.S. dollar has stalled since the summer of 2008, with its value relative to the dollar barely budging in the 12 months through June 2009. The case for undervaluation apparently weakened in the first half of 2009—the pace of China's reserve accumulation fell sharply as capital

[2]The TIC data probably understate the actual stock of Chinese holdings, particularly since purchases of U.S. financial assets that are routed through financial institutions in third countries are recorded as originating in those countries. Analysts believe that the actual stock of Chinese holdings of U.S. Treasury instruments is likely to be about $150–200 billion higher than the reported number (see, for instance, Setser and Pandey 2009).

inflows slowed and the trade surplus narrowed. But these developments do not alter the perception that the currency is kept at an undervalued level relative to its market equilibrium level.

While the exchange rate is a visible symbol of Chinese policies towards trade, there are in fact more subtle forms of protectionism that remain pervasive. For instance, through its repressed financial system that mainly consists of state-owned banks, China provides cheap capital to many of its enterprises. Subsidies to land and energy have also held down the effective cost of factors of production that are complementary to physical capital. These subsidies clearly give Chinese manufacturers a substantial cost advantage that translates into greater competitiveness in international markets. Here the United States is clearly not in a position to take the high road, now just having introduced massive state subsidies into its own financial system and auto industry.

The larger point is that the debate about China's currency is far too often framed in a narrow way that misses the broader context. What is essential for China is to have an independent monetary policy oriented to domestic objectives such as low inflation and stable growth. Flexibility of the currency is an essential prerequisite for this rather than an objective in itself. Giving the Chinese central bank room to raise or lower interest rates by freeing it from having to target a particular exchange rate would help rein in credit growth and deter reckless investment, reducing the risk of boom-bust cycles. An important point here is that an independent monetary policy requires a flexible exchange rate, not just a one-shot change in the value of the currency or even a managed "crawl" in which the exchange rate is allowed to appreciate gradually.

Independent monetary policy, in turn, is essential for financial sector reforms. Using market instruments such as interest rate policy, rather than government directives, to guide credit expansion is essential to train state-owned banks to respond to market signals and become more robust financial institutions. In the absence of such instruments, the central bank has to revert to its old practice of telling banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios and to behave like commercial entities. Moreover, maintenance of the fixed exchange rate over a prolonged period has been abetted by financial repression, which is another hidden but

substantial cost of the managed exchange rate.[3] Giving state-owned banks little choice but to purchase central bank bonds makes it much easier for the central bank to "sterilize" its intervention in foreign exchange markets and thereby maintain control of the domestic money supply to some extent.

In other words, focusing on the currency's level per se tends to obscure much deeper issues in terms of China's growth model and its consequences for the bilateral relationship. How the trade relationship between these two large economies evolves has the potential to set the tone for broader negotiations on countries' policies towards international trade.

Before considering the bilateral relationship in greater detail, however, it is useful to put this relationship into a global context. To do this, I now turn to the question of whether the U.S.-China relationship may have played a role in fomenting the worldwide financial crisis, as some observers have argued.

Global Macroeconomic Imbalances

There is a vigorous ongoing debate about whether global macroeconomic imbalances were the proximate cause of the global financial crisis. The narrative goes as follows. These imbalances have been characterized by large current account deficits in the United States and a few other advanced industrial countries, with these deficits financed by excess savings in China and many other emerging market economies. These excess savings in Asian and other emerging markets and the bloated revenues of oil-exporting countries were recycled into the U.S. financial markets since the surplus countries did not have well-developed financial markets for intermediating these savings into productive domestic investments. The inflows resulted in a prolonged period of low interest rates in the United States, creating incentives for aggressive search for yields by U.S. financial institutions and blocking self-correcting mechanisms such as rising interest rates that would normally have resulted from higher government borrowing and a low private saving rate.

Whatever one's view about the centrality of these imbalances versus problems in the U.S. financial system in triggering the crisis,

[3]Lardy (2008) estimates that the cost of financial repression, as reflected in the low or negative real rates of return on bank deposits, is borne by households and could be as high as 4 percent of GDP.

there is no doubt that global imbalances allowed problems in the U.S. financial system to fester and end in a cataclysm. More importantly, the underlying policies that generated those imbalances were clearly not in the long-term interests of the countries concerned themselves. A looming problem is that these imbalances could actually worsen over the short term, perpetuating macroeconomic problems in the main economies and possibly setting the stage for the global economy to take another tumble in the future.

Indeed, there is a rich set of ironies in the way the crisis has played out. First, the global macro imbalances are not unraveling in the way that most economists had expected. Rather than adjusting via a decline in the external value of the dollar, the U.S. current account deficit may apparently adjust with just a massive contraction in private consumption.[4] Second, the United States, which has been at the epicenter of the crisis, has become the ultimate financial safe haven, with the flight to quality around the world turning into a flight to U.S. Treasury bonds. Third, and most worrisome, the rest of the world still seems to be counting on the United States as a demander of last resort. Fourth, all signs are that the global crisis may lead to emerging markets rethinking old notions of reserve adequacy and consider building up even larger stocks of reserves.

In short, as the world economy pulls out of the crisis, the imbalances that created much of the problem could intensify rather than dissipate. This is why the solutions need to be global as well. Moreover, while much has been said about how to redesign financial regulation, this has to be supported by a clear focus on macroeconomic policies.

Prognosis

Before peering into the future, it is worth analyzing China's growth model in some detail for clues about how the effects of the global recession and eventual recovery might play out in its case. China's economy has maintained robust GDP growth in the range of 8–10 percent per annum for nearly a decade now, with the pace of growth even picking up by a couple of percentage points on average

[4]One cannot be too sanguine about the U.S. dollar, however, especially given the prognosis for the U.S. economy and its high levels of public deficits and debt. Indeed, during 2009, the U.S. dollar has depreciated against most other major currencies.

during 2003–07. The picture for 2009 is of course different as even China is not proving immune to the global crisis. What is remarkable of course is that despite the crisis and an apparent loss in the economy's momentum in the last quarter of 2008, it appears that the Chinese economy could still manage to hit 7–8 percent growth in 2009.

Even before 2009, during the high-growth years, there were certain features of the Chinese growth model that are worth noting.[5] First, investment has accounted for more than half of overall GDP growth, with net exports playing an important role as well since 2005. Private consumption, by contrast, has not been a key driver of growth. Second, even high GDP growth has not translated into much employment growth, with overall employment growth averaging only about 1 percent over the last decade.[6]

Thus, the Chinese government faces the twin challenges of rebalancing growth toward domestic consumption in order to make growth more welfare-enhancing for its citizens and of generating higher employment growth in order to maintain social stability. These challenges have of course taken on added urgency in light of the global recession.

To combat the effects of the slowdown, the Chinese government recently announced an aggressive fiscal stimulus. The net effect of this package in terms of new spending is on the order of 4–5 percent of GDP, much smaller than the headline number that was announced (about 16 percent of GDP) but still quite impressive. Much of this expenditure has gone toward investment projects and partly toward strengthening the social safety net. It is a package that tries to blend together short-term stimulus with longer-term objectives of developing infrastructure in underdeveloped parts of the country (particularly the provinces in the west) and boosting consumption.

However, Chinese household savings have been on a trend increase in recent years and the economic uncertainty is likely to increase saving for precautionary purposes (see Chamon and Prasad 2008). Thus, the fiscal stimulus could end up actually worsening the

[5]For more details, see Prasad (2009a).

[6]The annual growth rate of nonagricultural employment has averaged around 2.5 percent during this period, although this has to be set against the growth rate of nonagricultural output, which has been 2–3 percentage points higher than that of overall GDP.

balance of growth by tilting it even more toward growth led by investment and exports rather than private consumption. The reliance on exports is, as noted earlier, because it is a key source of job growth.

Even if China continues to rely on exports for growth, the recession and the rebuilding of household balance sheets in the United States implies that Chinese exports to the United States will almost certainly decline during 2009. Thus, the overall volume of trade between the two economies is likely to fall in tandem with the sharp fall in global trade. The U.S. bilateral trade deficit with China could still remain in the range of about $200 billion in 2009, especially if the U.S. fiscal stimulus generates a gradual recovery in U.S. domestic demand. China's overall current account balance, which is estimated to be about $370 billion (roughly 9 percent of GDP) in 2008, could well remain in the $300–350 billion range; the recent collapse in exports has been offset by an even sharper decline in imports.

What are the implications for financial flows between the two countries? This will of course depend on whether capital outflows in 2009 offset part of China's current account surplus and how aggressively China needs to intervene in foreign exchange markets to keep the renminbi from appreciating. Even with modest capital outflows and a significant fall in the current account surplus, it is highly likely that China will continue accumulating foreign exchange reserves in 2009, although at a substantially reduced pace than in previous years.

Ironically, given the turmoil in world financial markets and the dearth of safe and liquid financial instruments, China's reliance on U.S. Treasuries to park its accumulation of foreign exchange reserves is likely to intensify. Even during September to November 2008, when U.S. financial markets were in deep turmoil, Chinese purchases of U.S. Treasury bills and bonds amounted to nearly $123 billion. The continued flow of Chinese money into U.S. Treasuries is of course rather convenient for the United States at a time when it faces the prospect of having to finance a massive budget deficit.

During the first half of 2009, there has been a distinct shift in Chinese purchases of U.S. Treasury instruments from longer-term bonds to shorter-term bills. This shift has been interpreted as reflecting Chinese concerns about the risks of a fall in prices of long-term U.S. Treasury bonds due to rising debt levels and concomitant increases in inflationary expectations.

Clearly, the bilateral relationship between these two economies is complex, and they cannot easily disentangle themselves from the close but awkward embrace that they are locked in. The question is how to make this a more productive relationship that is driven by cooperation rather than conflict.

A Grand Bargain

I have recently proposed a grand bargain between the two countries that would cover two areas—macroeconomic policies and international economic affairs (see Prasad 2009b). None of the elements is particularly novel, but rolling them into a package that Chinese and U.S. leaders could jointly sign on to would provide domestic political cover for both sides to implement policies that are ultimately in their own interests. A joint announcement of cooperative actions would also give a sorely needed fillip to economic confidence around the world.

The grand bargain would have the following elements:

- *The two countries commit to using fiscal and monetary policy to the best extent possible to stimulate domestic demand in their own economies in the short run.* This is to reaffirm their resolve to follow through and deliver on their stimulus packages, increase the quantum of stimulus measures rapidly if the economic situation deteriorates further, and for China to signal that it will not count on exports to keep its economy and job growth from stalling.
- *The Chinese allow their currency to become more flexible and responsive to market forces while the United States articulates a plan that commits it to taming its budget deficit once the economy begins to recover.* This is an opportune time for China to allow more flexibility in its currency, as the pressures are evenly balanced and there is unlikely to be a sharp appreciation in the short run. But greater currency flexibility could have considerable long-term benefits for China by allowing its monetary policy to become more independent, reducing its dependence on exports and rebalancing its economy toward domestic consumption (see Prasad 2007). It would also ease pressure on the Chinese to revalue their currency by a large amount at one step. The U.S. will eventually need to tackle its mammoth budget deficit and rising public debt, which have contributed to

its current account deficit and dependence on funds flowing in from the rest of the world. A clearer commitment right now to bring the deficit down over a reasonable period after the economy gets back on its feet would reassure financial markets that U.S. government borrowing won't be allowed to get out of control and exacerbate global macroeconomic imbalances in the future.

- *The United States supports an expanded role for China in multilateral financial institutions,* including significantly greater voting rights at the IMF and a key role in the Financial Stability Forum. These are logical—indeed, necessary—steps to make these institutions more inclusive and effective in dealing with the many global challenges that lie ahead. They are also strongly desired by China, which feels that its role in such institutions is well beneath its true economic stature. While greater Chinese influence in international economic affairs is inevitable, the United States has some leverage as its prominent role in multilateral institutions means that it is in a position to speed up this realignment. Tying this issue into the grand bargain would allow China to assume its rightful place on the world stage soon.

With these steps, the United States could show that it is willing to enter into a genuine economic partnership with China that can benefit both sides and also demonstrate true leadership by accepting China's expanded role on the global stage. The Chinese could reaffirm to their restive citizens their commitment to restoring growth and jobs, and also be seen as getting the respect they deserve as a world power while doing their bit for global economic and financial stability. The political leadership on both sides has to step up to get beyond nationalistic sentiments and convince their people that, in this interconnected world, China and the United States will sink or swim together.

The Way Forward

Continued high-level engagement between the two economies on economic affairs should be an important priority for the new U.S. administration. The Strategic and Economic Dialogue proposed by the Obama administration, which would build on the Strategic Economic Dialogue initiated by former Treasury secretary Hank Paulson, can be a useful device to nurture this relationship.

Maintaining this avenue for high-level dialogue can help in building trust and a deeper awareness of political and other constraints that may be driving economic decisions on both sides. The visits to Beijing by Secretary of State Hillary Clinton and Treasury Secretary Timothy Geithner and return visits to Washington by various senior Chinese officials have already set a constructive tone for the more formal dialogue to follow.

Both countries have complex internal political dynamics that are difficult for outsiders to comprehend. Even in China, there are different locuses of power that are often at odds on matters of economic policy. Influencing the right people in both countries and helping them to influence others is as much a part of changing policy as is the substance of the message.

External pressure can play a helpful role in this reform process, but only if it is placed in the right context. For instance, the debate in the United States about the Chinese exchange rate regime has been distorted in some ways and made political rather than substantive by placing it in the narrow context of the U.S.-China trade balance. There is an important strategic (and educational) element related to reframing the exchange rate issue in a broader context, especially by relating it to more independent monetary policy and more effective financial sector reforms. This is where external pressure from the international community can be helpful, not in the form of threats but by reorienting the discussion in a fashion that brings into sharper focus the linkages between currency reform and other core reforms on which there is broad consensus within China (see Prasad and Rajan 2006).

Ultimately, as far as Chinese reforms are concerned, there is a set of shared interests between policymakers in China and the United States. For it is deep and enduring reforms that promote sustained and balanced growth in China that are in the best interests not just of China itself but also the United States and the world economy.

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