

# The Debt Threat: A Risk to U.S.–China Relations?

---

JAMES A. DORN  
Vice President for Academic Affairs  
Cato Institute

---

CHINA'S SUBSTANTIAL HOLDINGS OF U.S. government debt and the creation of a sovereign wealth fund (SWF) are causing concern that U.S. economic and national security may be at risk. Rapid economic growth, record current account surpluses, and a high domestic saving rate have allowed China to accumulate more than \$1.5 trillion in foreign exchange reserves, much of which is invested in U.S. government securities. This article examines the political and economic implications of China's rising share of U.S. public debt, and asks whether foreign-held debt is a real threat to U.S. prosperity or an excuse for economic nationalism.

151

## CHINA AND THE GROWTH OF FOREIGN-HELD U.S. PUBLIC DEBT

The United States must borrow from foreigners and sell them assets in order to finance the excess in U.S. domestic investment over domestic saving. At the same time, U.S. government budget deficits have added to the U.S. debt. Current private and government consumption, relative to gross domestic product (GDP), has been sustained only because foreigners have been willing to hold U.S. Treasury securities and invest in U.S. assets. The massive amount of dollars held by foreign central banks, which mostly end up being invested in U.S. Treasury and other government securities, has kept U.S. interest rates lower than otherwise and allowed U.S. domestic investment to exceed domestic saving.

In January 2008, the public held \$5.1 trillion of outstanding U.S. Treasury debt while intragovernmental holdings (for example, by the Federal Reserve and the Social Security "trust fund") amounted to \$4.1 trillion. The total national debt of roughly \$9 trillion does not include the trillions of dollars of unfunded liabilities in Medicare

---

JAMES A. DORN is a China specialist at the Cato Institute, editor of the *Cato Journal*, and professor of economics at Towson University. He is also co-editor of *China's Future: Constructive Partner or Emerging Threat?*

---

Copyright © 2008 by the *Brown Journal of World Affairs*

and Social Security that need to be met in the future.

Of the publicly held Treasury debt, foreigners now account for 44 percent, compared with 37 percent in 2003. Between 2003 and 2006, foreign ownership of U.S. Treasury securities increased from \$1.4 trillion to \$2.13 trillion—an increase of nearly 50 percent. What worries Congress is that China, the world’s largest communist country, now holds nearly 20 percent of the total foreign-held Treasury debt (more than \$400 billion) and is acquiring more than 50 percent of net new issues.<sup>1</sup> In addition, foreign investors held \$1.2 trillion in U.S. agency debt and government-sponsored enterprise securities at the end of 2006, more than double the amount held in 2001. China is now the largest holder of that debt with 23 percent of the total in 2006.<sup>2</sup>

Because the United States is living beyond its means—that is, spending more than its income—the gap between domestic saving and investment is reflected in an increase in net foreign claims on the United States (Figure 1). Those claims went from \$9 trillion in 2000 to \$13.6 trillion in 2005, an increase of 52 percent. Of that total, 17.4 percent represented foreign-held U.S. government (Treasury and other agency) debt, with most of that debt being held by foreign central banks rather than private investors.

	2000	2001	2002	2003	2004	2005
Total						
In trillions of dollars	9	9.3	9.3	10.7	12.5	13.6
As a percentage of U.S. GDP	91.5	91.5	88.5	97.2	106.9	109.4
Distribution (Percent)						
Total	100	100	100	100	100	100
Owned by foreign governments	11.5	12	13.5	14.7	16	16.3
Owned by foreign private sector	88.5	88	86.5	85.3	84	83.7
U.S. Government	12.9	13.4	15.8	16.2	16.6	17.4
Owned by foreign governments	8.6	9.3	10.7	11.3	12.1	12.2
Owned by foreign private sector	4.2	4	5.1	4.9	4.5	5.2
U.S. Private Sector	87.1	86.6	84.2	83.8	83.4	82.6
Direct investment	31	27.6	21.8	23	21.6	20.5
Stocks (by private foreigners)	17.3	15.9	13.5	16.1	15.7	15.5
Bonds (by private foreigners)	11.9	14.5	16.5	16.1	16.2	16.7
Stocks and bonds (by foreign governments)	1.1	1.2	1.2	1.5	1.7	1.9
Liabilities of U.S. banks	14.7	15.8	18.3	19.9	21.5	21.2
U.S. currency	2.8	3	3.3	3	2.7	2.6
Other	8.3	8.6	9.6	4.2	4	4.2
Source: P. R. Orszag, CBO Testimony (26 June 2007), 4.						

**Figure 1: Total Foreign Claims on the United States (2000–2005)**

The rise in foreign-held U.S. Treasury debt and the overall increase in claims against the United States are causing concern that the United States may end up being heavily indebted to oil-rich nations and to non-democratic countries like China, and that foreigners may end up owning a large chunk of the United States.

In particular, Congress is worried that China could use its large holdings of U.S. government debt to gain political leverage by threatening to dump those securities if the U.S. threatens to enact protectionist measures against China or to intervene in relations between the mainland and Taiwan. Washington is also concerned that the increasing economic power of China will be used to edge out the United States as the dominant power in Asia.

Even though China only accounts for about 25 percent of the U.S. overall current account deficit of around \$800 billion, many in Congress find it easier to bash China than to face the reality that the growth in U.S. government spending and borrowing, not the trade deficit with China, is the key reason for concern.

As early as 1988, William Niskanen, a member of President Reagan's Council of Economic Advisers, recognized that government profligacy, not the trade deficit, is the primary issue. According to Niskanen, "The increase in private and government consumption, financed in part by borrowing abroad, will not provide a stream of returns to finance the increased debt." Consequently, there must be "a reduction in the growth of either private or government consumption relative to the growth of output." He did not see the trade deficit as a problem, except insofar as it generated demands for protectionism.<sup>3</sup>

Niskanen concluded that the longer Congress ignored the primary debt problem and focused instead on foreign holdings, the worse it would become. That point continues to be valid, especially if one considers the overall U.S. government debt, including the more than \$40 trillion of unfunded liabilities in Social Security and Medicare. The most pressing issue facing Congress—and one it continues to ignore—is "to focus on the budget deficit, not the trade deficit."<sup>4</sup>

Today, the spotlight is still on the U.S. trade deficit, but now China, rather than Japan, is the target of discontent on Capitol Hill. And the "unfair trade" practice cited most frequently is China's undervalued exchange rate, which makes Chinese goods more competitive than at a more realistic dollar price of the yuan. Senator Charles Schumer and Senator Lindsey Graham even went so far as to threaten China with a 27.5 percent tariff on all Chinese goods entering the United States unless Beijing revalued the yuan by that amount (though the Schumer–Graham proposal was dropped in favor of less draconian measures).

It is important to recognize that reducing the federal budget deficit in the long run may not be sufficient to reduce the overall U.S. trade deficit—unless there is an

JAMES A. DORN

increase in the U.S. saving rate. So Congress should be thinking of how to promote private domestic saving and economic growth, rather than how to penalize China.

#### THE POLITICS OF FINANCIAL TERRORISM

Senator Hillary Clinton argues that dependence on foreign investors, particularly the Chinese, is causing “a slow erosion of our own economic sovereignty.” In a letter to U.S. Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke referring to China and other countries running large trade surpluses with the United States, she stated, “As we have been running trade and budget deficits, they have been buying

**The United States and China should do everything possible to avoid a policy of mutually assured economic destruction.** our debt and in essence becoming our banker.” The United States must “ensure foreign governments don’t own too much of our public debt,”

because “if China or Japan made a decision to decrease their massive holdings of U.S. dollars, there could be a currency crisis and the U.S. would have to raise interest rates and invite conditions for a recession.”<sup>5</sup> She says nothing about the need to cut the size of government.

So far the “balance of financial terror,” as former U.S. Treasury Secretary Lawrence Summers called the mutual damage that would occur to the U.S. and Chinese economies, as well as the global financial system, has kept China in check. Although the yuan has been appreciating against the dollar at a faster rate (nearly 13 percent in the fourth quarter of 2007), the People’s Bank of China (PBC) remains officially committed to the dollar as its major reserve currency. However, the expectation is that China and other Asian central banks will diversify, so that the dollar’s future status as a reserve currency could weaken relative to the euro—and the yuan could become a major currency for Asian trade by mid-century.

Although China has much to lose by reverting to financial terrorism and dumping the dollar, one could imagine scenarios in which China might speed up diversification in response to either U.S. protectionism or a conflict over Taiwan. The United States and China should do everything possible to avoid a policy of mutually assured economic destruction. To tell China we would retaliate with protectionist measures if Beijing fails to allow faster yuan appreciation, which would itself give the PBC an incentive to flee the dollar, is counter-productive. As Summers notes, “It surely cannot be prudent for us as a country to rely on a kind of balance of financial terror to hold back reserve sales that would threaten our stability.”<sup>6</sup>

It is estimated that the PBC holds more than \$600 billion of U.S. Treasury and agency debt, while Asian central banks, in total, hold at least \$2 trillion in dollar-de-

nominated assets, which account for 33 percent of U.S. government debt outstanding and 98 percent of foreign-held U.S. Treasury securities.<sup>7</sup> If U.S.–China relations were to deteriorate and the U.S. dollar’s international value continues to fall, China could decide to speed up its diversification out of dollar assets. Any abrupt movement out of the dollar would be detrimental to both China and to the United States: China would take a huge loss on its dollar-denominated assets and U.S. interest rates would increase, reducing asset prices.

Even though both Washington and Beijing have an incentive not to commit economic suicide, policy errors can occur—especially as protectionist pressures increase in Washington. If Congress were to pass onerous legislation designed to protect U.S. special interests under the guise of national security, Beijing’s patience and trust in U.S. policy could falter.

If other Asian central banks expected China to slowdown its purchase of U.S. debt, they would not want to lag too far behind, because the last one to sell dollar-denominated assets would receive the lowest prices. It is ironic that Congress sees China’s “unfair trade practices” (especially currency “manipulation”) as the biggest source of risk for this “hard landing,” rather than trace that risk to the protectionist mentality and fiscal disorder in Washington.

The low U.S. saving rate and the willingness of foreign investors to hold claims on the United States are behind the large U.S. current account deficit, which now stands at about 6 percent of GDP.<sup>8</sup> Voluntary international trade in goods and services creates wealth and is mutually beneficial. Consumers always gain, but some producers may lose market share—and those are the vested interests that politicize trade and go to Congress for relief. In the case of China, the U.S. hawks are joining forces with protectionists to demand “fair trade practices,” including a faster appreciation of the yuan.

#### **FAIR CURRENCY LEGISLATION AIMED AT CHINA**

There are now dozens of bills in Congress aimed at U.S.–Sino trade relations and several that would make it easier to label China a “currency manipulator” by showing that its currency is “fundamentally misaligned.” The acid test here would be China’s massive accumulation of foreign exchange reserves and its persistent trade surplus.

Under the Currency Exchange Rate Oversight Reform Act of 2007, China would be put on the U.S. Treasury’s “priority list,” and export prices would have to be adjusted for the undervalued currency in determining antidumping duties. That requirement would substantially expand antidumping cases brought against China and impede trade relations. The United States would simply buy fewer Chinese products and shift demand to other emerging market countries, probably in Asia, with little effect on the U.S. balance of payments.

Other pending legislation would treat a “fundamentally misaligned currency” as a countervailable export subsidy. In the past, China has not been subject to countervailing duties (CVDs) because it is still labeled a nonmarket economy (NME) by the United States. There is a good case to be made that China should be labeled a market economy and that U.S. antidumping law needs to be overhauled to end discriminatory practices.<sup>9</sup>

Although none of the so-called fair currency bills or other trade legislation aimed at penalizing China and protecting U.S. special interests has been enacted, there will be growing pressure to do so. One of the main recommendations of the U.S.–China Economic and Security Review Commission’s *2007 Report to Congress* is to “enact legislation to define currency manipulation as an illegal export subsidy and allow the subsidy to be taken into account when determining penalty tariffs.”<sup>10</sup>

Contrary to conventional wisdom, China is not an economic threat to the United States. U.S. consumers have saved billions of dollars by being able to freely buy cheap imports from China, and U.S. manufacturing performance was exceptionally robust in 2006, with record output and profits.<sup>11</sup> Likewise, China is by far the fastest growing market for U.S. exports, expanding by 32 percent in 2006.<sup>12</sup>

Blaming China for U.S. manufacturing job losses is misleading at best. In a dynamic global economy, there will always be a process of what Joseph Schumpeter called “creative destruction.” Changes in consumers’ preferences, technology, and foreign competition all destroy some jobs when workers move to higher valued employments, as perceived by market participants. The purpose of both domestic and foreign trade is

156

**In a dynamic global economy, there will always be a process of what Joseph Schumpeter called “creative destruction.”** to create wealth, not work. Dan Griswold, a trade analyst at the Cato Institute, has estimated that U.S. trade with China, on net, accounts for only one percent of total U.S. job displacement.<sup>13</sup> Should third parties harmed by trade have the right to use the power of government to deny others who gain from trade the right to enter into mutually beneficial transactions, provided there is no credible threat to national security? To do so would undermine the very principles that have made the United States a “great society.”

Congress should also recognize the progress China has made in liberalizing its economy. Economic engagement is a sounder path toward the civil society that Congress would like China to develop than threats of destructive protectionism that would disrupt global trade and reduce the wealth of nations.

**FROM DEBT TO SOVEREIGN WEALTH FUNDS**

As China accumulates more foreign exchange reserves and the dollar continues to fall on a trade-weighted basis, it makes sense for the PBC and other Asian central banks to gradually hold a smaller proportion of their reserves in dollars and to switch from low-yielding Treasury debt to higher-yielding investments. Those adjustments are necessary to help restore global balances, but they also send a signal that the dollar's future value as the only anchor currency is at risk.<sup>14</sup>

The creation of China's new SWF, the China Investment Corporation (CIC), with an initial injection of \$200 billion, is a step by China to move from U.S. debt holdings to higher-yielding investments. This new fund and other SWFs pose a special challenge to Congress: if foreign investments in U.S. companies are too heavily regulated, China and other non-democratic countries that may be discriminated against will go elsewhere. The Chinese are searching worldwide for joint ventures and for strategic assets. If Americans wish to sell their assets to foreign buyers, including SWFs, where should the line be drawn? In a free society, the presumption is that private owners have the right to sell their assets to whomever they wish, provided there is no credible security threat.

The Committee on Foreign Investment in the United States (CFIUS) is responsible for vetting foreign direct investment (FDI) that poses a "credible threat" to U.S. national security. Of nearly 2,000 cases reviewed by CFIUS since 1988, only a few were fully investigated and sent to the president, and in only one case did the president order a divestiture.<sup>15</sup> In 2006, only 6.5 percent of all U.S. cross-border transactions were subject to CFIUS review; none were blocked.<sup>16</sup> Congress recently improved the review process by passing the Foreign Investment and National Security Act of 2007, which President Bush signed into law on July 26. FINSAs strengthens the role of CFIUS, increases transparency and accountability, and ensures that foreign investments that do not endanger U.S. security will be welcomed.<sup>17</sup>

China's sovereign wealth is sure to grow. Figure 2 shows that at the end of 2006, China owned foreign assets worth \$1.63 trillion, with most of those in the form of foreign exchange reserves. Even if China's economic growth slows and its current account surplus narrows, reserves will continue to increase and some of those funds will end up with the CIC. At the same time, foreign claims on China, which now stand at \$965 billion will continue to grow, so China's net international investment position could narrow.

A large part of China's foreign-owned assets are denominated in dollars, probably \$1.4 trillion at the end of June 2007.<sup>18</sup> That sum will continue to increase for some time. The anti-China hyperbole surrounding U.S.–China trade has ignored the

progress China has made and the net benefits for the global trading order. Now that China has established a SWF, there will be even more worries on Capitol Hill and more legislation aimed at “protecting” U.S. interests from an invasion of Chinese capital. Yet, it would be much wiser to allow China to invest in the private sector, rather than to accumulate more U.S. public debt that would allow the federal government to continue on its spending spree.

China's International Investment Position, 2006 (Billions of USD)			
	Assets	Liabilities	Net
Direct	82	544	-462
Securities	229	121	109
Other	242	300	-58
Reserves	1,073	0	1,073
Total	1,627	965	662

Source: S. Green, “What’s Mine Is Yours, What’s Yours Is Mine,” *Standard Chartered On the Ground* (9 November 2007), 1.

**Figure 2: China's International Investment Position**

158

In judging China's SWF, Congress should heed the advice of U.S. Treasury Deputy Secretary Robert Kimmitt, who views SWFs as “a force for financial stability,” given their long-run strategic outlook. He points to the benefits of foreign investment in terms of increasing U.S. productivity and employment, and warns against “investment protectionism . . . masked by claims of national security concerns or driven by individual firms that might lose out in a given deal.” Congress should let CFIUS do its job and establish a positive framework for SWFs, and then leave them alone to invest their funds.<sup>19</sup>

SWFs should have transparent rules and be politically astute in their investment decisions. The United States should welcome foreign investment but be alert for genuine national security risks. What the United States should not do is to let those concerns become a form of disguised protectionism, which was surely the case when Congress intervened to prevent a subsidiary of the state-owned China National Offshore Oil Company (CNOOC) from acquiring Unocal.<sup>20</sup>

China's search for higher returns on its reserve holdings, its demand for technology, and its desire for natural resources are sure to lead to further attempts to acquire U.S. companies. The risk is that Congress might impede CFIUS's work by directly intervening in politically sensitive deals as happened in the case of CNOOC.



**ECONOMIC EFFECTS OF FOREIGN-HELD DEBT**

We have already seen that when the United States runs a current account deficit, there must be net capital inflows (i.e., a capital account, or more precisely financial account, surplus) to fund the gap between domestic savings and investment. The United States needs to increase private domestic saving and cut the size of the budget deficit, preferably by slowing the growth of government spending rather than increasing taxes. Cutting *marginal* tax rates on saving and investment, meanwhile, would help promote U.S. growth. Downsizing government and tax reform would reduce the growth of U.S. public debt relative to GDP, and increase the standard of living for future consumers.

Limited government, strong private property rights, and open markets were the hallmarks of the U.S. economy during the first wave of globalization in the nineteenth and early twentieth centuries. Economic growth was strong and the United States ran persistent trade deficits financed by foreign investment and borrowed from foreigners for private investment—not to fund government deficits. Limiting government growth would help strengthen property rights, and adhering to free trade in goods and capital would encourage foreign investment in the U.S. private sector. Running a trade deficit under those conditions would not be a problem.

When foreigners hold U.S. government debt, they do U.S. taxpayers a favor by keeping interest rates lower than otherwise; they also promote U.S. growth by allowing greater private investment than would occur if government competition for funds bid up the price of loanable funds (the interest rate) and “crowded out” private investors. Diana Farrell, director of the McKinsey Global Institute, and her colleagues estimate that foreign central bank purchases of U.S. government debt in 2006 lowered long-run interest rates on U.S. government debt by 0.68 percent (68 basis points). Of that amount, Asian central banks contributed 55 basis points—most of which (41 basis points) was due to China.<sup>21</sup>

Although the impact of Chinese purchases of U.S. public debt on interest rates is relatively small, any significant move out of dollars could change market expectations and have a magnified impact on U.S. capital markets. It is unlikely that China would make any major move away from the dollar, but over time the PBC will surely hedge its bets and hold a smaller proportion of its assets in dollars, including U.S. Treasury securities.

Foreign-held U.S. public debt lowers U.S. interest rates, but it does not remove the burden on future taxpayers to pay off the debt and to cover interest expenses. When Congress focuses on China’s leverage over U.S. capital markets—that is, the threat to domestic holders of U.S. assets if China were to dump its holdings of dollar-denominated securities—attention is diverted from the fact that excessive government spending

JAMES A. DORN

is placing a large burden on *future* U.S. taxpayers who must ultimately finance today's budget deficits. What is important is not the percentage of U.S. public debt held by foreigners but, rather, the overall U.S. debt as a percentage of GDP, and its growth relative to GDP.

While the United States needs to pay more attention to getting its own fiscal house in order and increasing U.S. savings, China needs to further liberalize its financial sector and to allocate funds more efficiently so that its high saving rate can be reduced. Doing so would reduce its large current account surplus and bring about more balanced growth.

Financial repression in China distorts macroeconomic prices—the interest rate and the exchange rate—and misallocates capital. State-owned banks lend to state-owned enterprises at low real interest rates, and use the vast pool of domestic savings to do

**When problems arise, it is easier for Congress to shift blame to the Chinese who don't vote in U.S. elections, rather than accept full responsibility for government failure.**

so. Savers have few investment options and are willing to deposit their funds at state-owned banks at low interest rates. The PBC, meanwhile, buys dollars to keep the yuan undervalued and to spur

exports. Under this “market socialist” regime, China lacks capital and exchange rate freedom—and the central bank must “sterilize” capital inflows by selling bills to the commercial banks to avoid inflation.<sup>22</sup>

It is in China's interest to move toward a more flexible exchange rate, allow convertibility on the capital account, and have an independent monetary policy aimed at long-run price stability. Major institutional changes are necessary, and that means political consensus at the cabinet level. The United States would be naïve to think that Congress can bring about such changes by threats of protectionism. Restricting trade with China would be self-defeating and endanger the “peaceful development” approach China has taken since 1978.

China's massive holdings of foreign exchange allow it to be a prime customer for U.S. government debt. If the yuan were allowed to appreciate and if China liberalized its financial sector and reduced its domestic saving rate, China's trade surplus would narrow, which would reduce protectionist pressures from the United States and the European Union.

#### THE DANGER OF ECONOMIC NATIONALISM

In his closing remarks at the Third Strategic Economic Dialogue (SED) in Beijing, in December 2007, U.S. Treasury Secretary Henry Paulson stated that both China and

the United States “recognize the need to fight economic nationalism in our two nations.”<sup>23</sup> Yet, it is much easier for Congress to politicize U.S.–China trade than to be patient and engage in the SED initiated by Secretary Paulson. It is also much easier to use China as a scapegoat than to make the hard political decisions at home necessary to reduce the U.S. budget deficit—not by increasing taxes but by cutting spending. Implementing tax and regulatory reforms that increase the incentive to save would also be positive steps toward improving the U.S. saving rate and narrowing the U.S. global current account deficit.

Of course, if secure private property rights and low marginal tax rates attract foreign investors to the United States, and U.S. productivity is strong, then the United States can run healthy current account deficits. But if foreign investors are holding large amounts of U.S. government debt, and that debt is financing current consumption rather than productive investment, U.S. current account deficits will not be so healthy. Yes, voluntary exchanges in both the market for goods and in the market for government securities will yield net benefits for current consumers and investors, but only at the expense of future taxpayers who will receive no net benefits.

Unlike special interest groups that are harmed by trade, no one represents future generations who will have a lower standard of living because of present government profligacy. And when problems arise, it is easier for Congress to shift blame to the Chinese who do not vote in U.S. elections, rather than accept full responsibility for government failure. Doing so, however, fans the flames of economic nationalism. The Chinese see U.S. efforts to politicize trade as a threat to future economic growth and to China’s aspiration to be a normal rising power while many in Congress see China’s rise as a threat to U.S. economic and national security.<sup>24</sup>

Although China has allowed the yuan to appreciate against the dollar by more than 14 percent since July 2005, Congress has done little to cut the growth of the federal government and increase the saving rate. Paulson correctly notes, “The yuan exchange rate has become a touchstone for broader anxieties about competition from China. As globalization advances and economies become more tightly integrated, worries about the effects of foreign competition have fueled economic nationalism and protectionist sentiments.” The truth is that neither China nor the United States “can protect its way to prosperity.”<sup>25</sup>

The policy of engagement has worked well to bring about mutually beneficial gains from trade with China. Upon joining the WTO in December 2001, China made major concessions to demands for safeguarding special interests in the United States and Europe. Even before joining the WTO, China had made significant progress in reducing tariff and non-tariff barriers.<sup>26</sup> That progress should not be minimized. The United States should practice what it preaches by adhering to market-liberal principles.<sup>27</sup>

Keeping our markets open sends an important signal to the rest of the world, and getting our fiscal house in order—by trimming the size of government and by real tax reform—would show we mean business.

China, meanwhile, would do well to imitate Hong Kong’s “small government, big market” model of development. With better protection of private property rights and with deeper, broader markets, China would move closer toward a normal balance of payments and be a net importer of capital. As John Greenwood, the architect of Hong Kong’s currency board, argues, “If China’s capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership),

**One should not underestimate the power of economic freedom in bringing about political reforms that would move China in the direction of a more liberal society.**

then China’s balance of payments would no doubt undergo a major transformation.”<sup>28</sup> Those institutional changes should be the focus of U.S. policy, rather than the narrowly conceived policy of pushing China to accelerate appreciation of the yuan.

Congress must recognize that major institutional changes are still needed in China and that external pressure alone would not change China. Ultimately, the Chinese people will have to determine the kinds of institutions they want. One should not underestimate the power of economic freedom in bringing about political reforms that would move China in the direction of a more liberal society. As per capita incomes have risen, China’s growing middle class has demanded stronger safeguards for private property, and, in response, the National People’s Congress has amended the constitution and enacted a new civil code to recognize private property rights and to provide legal safeguards.

President Hu Jintao’s “big idea” is to create a “harmonious and prosperous society” via “peaceful development.” The United States should welcome that idea and treat China as a normal rising power, not as a probable adversary. By following a policy of engagement and allowing China to take a larger stake in the U.S. private sector, Washington would provide Beijing with an incentive to behave as a “responsible stakeholder.”<sup>29</sup> Congress should place less emphasis on “intent” and more on observable behavior. In the words of Liu Junning, a Chinese liberal, “Whether China will be a constructive partner or an emerging threat will depend, to a very great extent, on the fate of liberalism in China: a liberal China will be a constructive partner; a nationalistic and authoritarian China will be an emerging threat.”<sup>30</sup>

## CONCLUSION

The U.S. trade deficit and the foreign-held share of U.S. public debt should not be used as decoys to divert attention from the imbalance between domestic saving and investment driven in large part by too much government chasing too few markets. Shrinking the size and scope of government to increase economic growth and generate more domestic savings is the main challenge that lies ahead.

Economic nationalism can only divert attention from that goal and interfere with productive and peaceful U.S.–China relations. The United States' economic and national security is best protected by a strong rule of law and the safeguarding of economic and personal freedoms, not by crude protectionism. Individual sovereignty under the rule of law has always been a hallmark of U.S. freedom. We should not let a growing national debt and excessive government taxing and spending destroy that heritage in favor of “economic sovereignty” or “investment protectionism.”

If China follows a more market-liberal path and the U.S. refrains from protectionism and is fiscally prudent, U.S.–China relations should evolve peacefully and global prosperity will continue. The “balance of financial terror” strategy would then give way to a more positive agenda for free trade and capital freedom, allowing markets to work their magic. 

## NOTES

1. Peter R. Orszag, “Foreign Holdings of U.S. Government Securities and the U.S. Current Account,” CBO Testimony before the Committee on the Budget, U.S. House of Representatives, 26 June 2007, 2; Stefan Kern, “Sovereign Wealth Funds: State Investments on the Rise,” Deutsche Bank Research, *Current Issues* (10 September 2007), 10.

2. Orszag, “Foreign Holdings,” 3.

3. William A. Niskanen, “The Uneasy Relation between the Budget and Trade Deficits,” *Cato Journal* 8 (Fall 1988), 516–517. Reprinted in James A. Dorn and William A. Niskanen, eds., *Dollars, Deficits, and Trade* (Boston: Kluwer Academic Publishers, 1989).

4. *Ibid.*, 517.

5. Tom Curry, “Clinton Sounds the China Alarm as '08 Issue,” MSNBC.com, <http://www.msnbc.msn.com/id/17403964>.

6. Lawrence Summers, “The United States and the Global Adjustment Process,” Speech at the Third Annual Stavros S. Niarchos Lecture, Institute for International Economics, 23 March 2004.

7. D. Farrell, et. al., *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Markets* (San Francisco: McKinsey Global Institute, 2007), 71, 83.

8. In 2006, the U.S. saving rate, after accounting for capital depreciation, was only 2 percent of income; the rate of net private domestic investment, meanwhile, was 8 percent of income. The difference was reflected in the U.S. current account deficit, and was financed by capital inflows—that is, by increases in net foreign claims on the United States. Orszag, “Foreign Holdings,” 1.

9. Daniel Ikenson, “Nonmarket Nonsense: U.S. Antidumping Policy toward China,” *Trade Briefing Paper No. 22*, Cato Institute Center for Trade Policy Studies, 7 March 2005.

10. U.S.–China Economic and Security Review Commission, *2007 Report to Congress* (Washington DC: U.S. Government Printing Office, 2007), 16.

## JAMES A. DORN

11. Daniel Ikenson, "Thriving in a Global Economy: The Truth about U.S. Manufacturing and Trade," Trade Policy Analysis No. 35, Cato Institute Center for Trade Policy Studies, 28 August 2007.
12. U.S.–China Commission, 25.
13. Daniel Griswold, "Who's Manipulating Whom? China's Currency and the U.S. Economy," *Trade Briefing Paper No. 23*, Cato Institute Center for Trade Policy Studies, 11 July 2006.
14. Wolfgang Münchau, "Dollar's Last Lap as the Only Anchor Currency," *Financial Times*, 26 November 2007, 11.
15. Kern, "Sovereign Wealth Funds," 10. Also see Dorn, "U.S.–China Relations in the Wake of CNOOC," Cato Institute Policy Analysis No. 553, 2 November 2005, 5.
16. Robert M. Kimmitt, "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy," *Foreign Affairs* 87, no. 1 (January/February 2008): 123.
17. Kern, "Sovereign Wealth Funds," 10.
18. Stephen Green, "What's Mine Is Yours, What's Yours Is Mine," Standard Chartered, 9 November 2007, 5.
19. Kimmitt, "Public Footprints," 122, 126–127.
20. Dorn, "U.S.–China Relations in the Wake of CNOOC."
21. Farrell, et. al., *The New Power Brokers*, 84.
22. See Dorn, "Ending Financial Repression in China," *Global Economic Review* 35, no. 2 (2006): 231–238.
23. Quoted in Le Tian and Li Fei, "Dialogue Declared a Success," *China Daily*, 14 December 2007, 1.
24. Dorn, "Nationalistic Barriers," *South China Morning Post*, 13 December 2007.
25. Henry M. Paulson, "Pulling Together: The Sino–U.S. Economic Dialogue Has Gone a Long Way in Lowering Barriers and Raising Trust," *South China Morning Post*, 12 December 2007.
26. Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, D.C.: Brookings Institution Press, 2002). See chapter 2.
27. Alan Greenspan warns against what he calls "creeping protectionism." Greenspan, "The Evolving U.S. Payments Imbalance and Its Impact on Europe and the Rest of the World," *Cato Journal* 24, no. 1–2 (2004): 1–11.
28. John Greenwood, "The Impact of China's WTO Accession on Capital Freedom," *Cato Journal* 21, no. 1 (2001): 93.
29. On the case for engagement and capital freedom, see Dorn, "U.S.–China Relations: The Case for Economic Liberalism," *Cato Journal* 26, no. 3 (2006): 425–443.
30. Liu Junning, "The Intellectual Turn: The Emergence of Liberalism in Contemporary China," *China's Future: Constructive Partner or Emerging Threat?*, eds. Ted G. Carpenter and J. A. Dorn (Washington DC: Cato Institute, 2000), 60.