

# China as the World's Creditor and the United States as the World's Debtor

Implications for Sino-American Relations

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**ABSTRACT:** China is now the world's leading creditor nation, while the United States is the world's largest debtor. Beijing is the largest foreign holder of US government debt – passing Japan in 2008 to become, in effect, the US government's largest foreign creditor. While some claim this gives Beijing unprecedented power over the United States, others claim that China's power is in fact greatly circumscribed. This paper shows that although current patterns of economic interdependence between the two economies invariably pushes each towards cooperation, China is deeply concerned about the future trajectory of the US economy and is already engaged in loosening the bonds of interdependence. This has profound implications for Sino-US relations and the global economy.

On 3 April 2010, the Obama administration announced that it would delay publication of the semi-annual exchange rate report to Congress (due on 15 April) containing the international economic and exchange rate policies of America's major trading partners. The report was eagerly awaited because it would officially state the Obama administration's position on China's exchange rate policy, in particular whether Treasury Secretary Timothy Geithner would declare China a "currency manipulator." Instead, striking a measured tone, Geithner tactfully noted, "China's inflexible exchange rate has made it difficult for other emerging market economies to let their currencies appreciate. A move by China to a more market-oriented exchange rate will make an essential contribution to global rebalancing." Geithner noted that "the best avenue for advancing U.S. interests at this time" is via discussions in multilateral and bilateral forums, including that of the G-20 finance ministers and central bank governors in late April; the semi-annual Strategic and Economic Dialogue between the United States and China in May; and during the meeting of G-20 leaders and finance ministers in June.<sup>(1)</sup> To further assuage Beijing, Geithner 7 April made an impromptu 75-minute stopover at the VIP terminal of Beijing airport (on his way to India) to meet with Vice Premier Wang Qishan (China's leading finance official) to "exchange views on U.S.-China economic relations and the global economy."<sup>(2)</sup>

The Treasury's conciliatory message was no doubt intended to deescalate tensions that had been brewing for months between Beijing and Washington. In fact, the latest round of the war of words began during Geithner's confirmation hearing (in January 2009) for Treasury Secretary when he bluntly stated that both he and "President Obama – backed by the conclusions of a broad range of economists – believe that China is manipulating its currency."<sup>(3)</sup> Geithner's tough rhetoric brought nods of approval from the members of the

1. "Statement of Treasury Secretary Geithner on the Report to Congress on International Economic and Exchange Rate Policies," 3 April 2010, United States Department of the Treasury, no. TG-627, <http://www.ustreas.gov/press/releases/tg627.htm>.
2. Bill Powell, "Why Geithner Made A Surprise Stop in Beijing," *Time*, 8 April 2010, <http://www.time.com/time/world/article/0,8599,1978666,00.html?xid=rss-fullworld-yahoo>; and Keith Bradsher, "China Seems Set to Loosen Hold on Its Currency," 8 April 2010, *The New York Times*, <http://www.nytimes.com/2010/04/09/business/global/09yuan.html?ref=business&src=me&pagewanted=print>.
3. In his written statement to the Senate panel, Geithner noted then senator Obama's support for "tough legislation to overhaul the US process for determining currency manipulation and authorizing new enforcement measures so countries like China cannot continue to get a free pass for undermining fair trade principles." However, the Obama administration quickly backtracked from Geithner's statement and declined to label China a "currency manipulator." Rather, the administration noted that while it still believes that the *yuan* is undervalued, it also recognises that China has taken steps to rebalance its economy and enhance exchange-rate flexibility. See Lori Montgomery and Anthony Faiola, "Geithner Says China Manipulates Its Currency," *The Washington Post*, 23 January 2009, p. A08, [http://www.washingtonpost.com/wp\\_dyn/content/article/2009/01/22/AR2009012203796.html](http://www.washingtonpost.com/wp_dyn/content/article/2009/01/22/AR2009012203796.html); and also, "Statement by Treasury Secretary Timothy Geithner on Release of Semi-Annual Report to U.S. Congress on International Economic and Exchange Rate Policies," 15 April 2009, <http://www.treas.gov/press/releases/tg90.htm>.

Senate Finance Committee – many of whom have long rallied against Beijing's alleged malpractice and were now hoping for a firm stance against China from the new Obama administration. However, to the markets, Geithner's clumsy and accusatory tone signalled a potential confrontation between the world's largest and third largest economies. The already jittery markets responded almost immediately as investors became concerned that China might scale back its purchase of US debt if the new administration pushed Beijing to further revalue its currency: the dollar promptly fell, the price of gold jumped by \$40, and the price of Treasury debt was driven lower.<sup>(4)</sup> Although Geithner tried to gloss over his remarks by stating that what he actually meant was for China to adopt "market exchange rates," it brought only short respite to this sensitive subject.

Clearly slighted, the usually unflappable Chinese Premier Wen Jiabao fired back by blaming the US-led financial system for the world's economic crisis. Wen, the first Chinese premier to visit the annual global meeting of the world's powerful in Davos (Switzerland), delivered an uncharacteristically stinging indictment against the West, in particular, the United States; although he did not directly name the United States, the target of his remarks was unmistakable. Wen blamed an "excessive expansion of financial institutions in blind pursuit of profit," a failure of government supervision of the financial sector, and an "unsustainable model of development, characterized by prolonged low savings and high consumption" for the global financial crisis.<sup>(5)</sup> Again, on 14 March 2009, speaking at a news conference at the end of the Chinese parliament's annual session, Wen said he was "worried" about the safety of China's over \$1 trillion investments in American government debt and that Beijing was watching economic developments in the United States closely. Wen expressed concern that the massive stimulus expenditures in the US could lead to soaring deficits – which in turn could sink the dollar's value and thereby China's massive investments. With so much at stake, Wen broke with protocol by lecturing Washington on financial management – urging the Obama administration to focus on important matters such as providing guarantees that China's investment in the United States would keep its value. Wen bluntly noted: "We have lent a huge amount of money to the USA. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried... the United States must maintain its good credit, honor its promises and guarantee the safety of China's assets."<sup>(6)</sup> In order to reassure Beijing, President Obama (the

leader of the world's largest debtor nation), promptly replied, stating, "Not just the Chinese Government, but every investor can have absolute confidence in the soundness of investments in the U.S." In addition, Obama also pledged to support China's long-standing demand for greater voting power within the IMF (International Monetary Fund).<sup>(7)</sup>

Yet, despite these assurances China remained concerned. On 24 March 2009, unambiguously underscoring Beijing's fear that the rapidly growing US budget deficits could drive down the dollar and with it the value of China's investments (especially in US Treasuries), Zhou Xiaochuan, the indefatigable Governor of the People's Bank of China, called for the creation of a new international reserve currency (which he termed a "super-sovereign reserve currency") to replace the dollar because "an international reserve currency that is disconnected from individual nations is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies."<sup>(8)</sup> On 26 June 2009, the People's Bank again renewed its call for a new global currency, noting that the IMF should manage more of members' foreign-exchange reserves. Since countries acquire portfolios of foreign exchange when they limit the appreciation of the currencies in the face of balance-of-payment surpluses, China, which holds a massive portfolio of foreign exchange (mostly in dollar-denominated assets), now claimed that the credit-based national reserve currencies (like the dollar) contributed not only to global imbalances, but also to financial crises. To Zhou, a new currency reserve system controlled by the IMF would be more stable and more economically viable because it would be used for international trade, financial transactions, and commodity pricing. In essence, Zhou's proposal suggested a "gradual" replacement of the dollar with Special Drawing Rights (SDRs) – which was introduced by the IMF in 1969 as an international reserve to support the Bretton Woods fixed ex-

4. Treasury securities are the debt financing instruments of the US Federal government. They are often referred to as Treasuries. There are four types of marketable treasury securities: Treasury bills, Treasury notes, Treasury bonds, and Treasury Inflation Protected Securities (TIPS).
5. Julian Glover, "Wen the Premier speaks," *The Guardian*, Wednesday, 28 January 2009, <http://www.guardian.co.uk/commentisfree/2009/jan/28/wen-jiabao-china-davos/print>.
6. Michael Wines, "China's Leader Says He Is 'Worried' Over U.S. Treasuries," *The New York Times*, 14 March 2009, [http://www.nytimes.com/2009/03/14/business/worldbusiness/14china.html?\\_r=1&pagewanted=print](http://www.nytimes.com/2009/03/14/business/worldbusiness/14china.html?_r=1&pagewanted=print).
7. Chinese President Hu Jintao has long called for expanding China's voting rights at the IMF. Currently the members of the European Union have a combined 32 percent of voting rights, the US has 17 percent, while China has 3.7 percent and India 1.9 percent.
8. Zhou's statement is published in English and Chinese on the central bank's (People's Bank of China) website: "Reform the International Monetary System," 23 March 2009, <http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178>.

change rate regime.<sup>(9)</sup> Zhou's proposal would expand the basket of currencies that currently constitutes the basis of SDR valuation to all large economies (such as Russia) and set up a settlement system between SDRs and other currencies so they could be used in international trade and financial transactions. This would mean, first, that countries would entrust a portion of their SDR reserves to the IMF to manage collectively on their behalf, and second, that SDRs would gradually replace existing reserve currencies.

If China's fixation on the safety of its huge dollar reserves was meant to obfuscate its currency conundrum, it clearly did not work. The ubiquitous issue of China's allegedly artificially undervalued currency (the *renminbi*, also called the *yuan*) would not go away.<sup>(10)</sup> By allowing the *renminbi* to modestly appreciate from 2005 to 2008, China had managed to placate its critics.<sup>(11)</sup> However, under intense pressure during the subprime-induced global financial crisis, Beijing was forced to resume its earlier practice of pegging the *renminbi* to a nearly fixed rate to revive its faltering export-dependent economy. Since the People's Bank of China (the country's central bank) tightly controls the *renminbi*'s movements through its interventions in the market, Beijing has kept its currency pegged at near 6.83 *yuan* per US dollar since mid-2008 to help its companies compete amid weak global demand.<sup>(12)</sup> To critics, this was just the latest of Beijing's blatant acts. By deliberately keeping the *yuan* undervalued, Beijing gains unfair advantages for its exporters; a free-floating *yuan* would erode China's advantage, and with it much of the global "imbalance" in world trade.

Predictably, Beijing's decision only galvanised the critics and triggered a torrent of sharp condemnations. In March 2010, some 130 House members (both Democrats and Republicans) sent a strongly-worded letter to Geithner demanding that he takes immediate action, including declaring China a "currency manipulator" and imposing tariffs and other punitive measures to force Beijing to stop manipulating the value of its currency to gain an unfair trade advantage. A number of influential lawmakers, including the overzealous but influential senators Charles Schumer (Democrat) and Charles Grassley (the top Republican on the Senate Finance Committee), even proposed legislation to effectively threaten China with trade sanctions for deliberately undermining global trade through its undervalued currency – as the *yuan* undervalued by some 40 percent gives Chinese exporters an unfair price advantage.<sup>(13)</sup>

Beijing's response has been equally swift and uncharacteristically terse – adding fuel to an already explosive subject. Commerce Minister Chen Deming accused the United

States of politicising and exaggerating the issue, and in a blistering public statement made clear that China would not take kindly to such actions stating, "If [the Treasury Department's] reply is accompanied by trade sanctions and trade measures, we will not ignore it." Chen warned, "If some congressmen insist on labeling China as a currency manipulator and slap punitive tariffs on Chinese products, then the [Chinese] government will find it impossible not to react... If the United States uses the exchange rate to start a new trade war, China will be hurt. But the American people and US companies will be hurt even more." Chen also indignantly dismissed US criticisms,<sup>(14)</sup> reiterating Premier Wen Jiabao's

9. However, in the late 1960s, when the US dollar liabilities to foreign nations exceeded the US gold stock, it brought into question the core commitment of the Bretton Woods system – the US promise to convert all dollars held abroad into gold at a fixed price (\$35 per ounce of gold). Although, the Bretton Woods regime collapsed in 1973, the value of SDRs is still based on a basket of four currencies – the US dollar, yen, euro, and pound sterling. The IMF initially defined the SDR in terms of a fixed amount of gold and allocated 9.3 billion SDRs between 1970 and 1972 to member countries in proportion to their quotas. Following the adoption of floating exchange rates in the mid-1970s, the IMF redefined the SDR as a weighted average of the US dollar, the British pound, the Japanese yen, and the currencies that eventually comprised the euro. However, the SDR never supplanted the dollar as a reserve currency unit. Rather, it devolved into a unit of account, and despite frustration about the dollar's role as a reserve currency (especially during times when the dollar depreciated on a broad basis) the US dollar remains the world's key international currency.
10. The *renminbi* is the name of the Chinese currency, while the *yuan* is one unit of the currency.
11. Between July 2005 and 2008, a managed currency float saw the *yuan* gradually gain 21 percent against the dollar.
12. According to the Bank for International Settlements, from July 2005 to February 2009, the *yuan* rose by 28 percent in real trade-weighted terms. However, the sharp export contraction forced Beijing to repeg the *yuan* to the dollar. Since February 2009, the *yuan*'s real trade-weighted value has lost about 8 percent. Of course, disagreement persists regarding the extent to which the *yuan* is undervalued – with claims ranging from 10 percent to 30 percent. For a recent view, see Arvind Subramanian, "New PPP-Based Estimates of Renminbi Undervaluation and Policy Implications," *Policy Brief*, no. PB10-8, April 2010, Washington, DC, Peterson Institute for International Economics.
13. Schumer made clear that he would push a bill to impose anti-dumping duties on some Chinese goods and countervailing tariffs on all of them if Beijing did not allow its currency to strengthen.
14. John Pomfret, "China's Commerce Minister: U.S. has the most to lose in a trade war," *Washington Post*, Monday, 22 March 2010, A06; and Gillian Wong, "China warns US against sanctions over currency," *Associated Press*, 21 March 2010, [http://news.yahoo.com/s/ap/20100321/ap\\_on\\_bi\\_ge/as\\_china\\_trade/print](http://news.yahoo.com/s/ap/20100321/ap_on_bi_ge/as_china_trade/print). Striking a more conciliatory tone, Zhong Shan, Chinese vice-minister of commerce, in an op-ed in *The Wall Street Journal* argued that "there is little connection between the trade balance and the value of the renminbi." On the contrary, "China-U.S. trade and economic cooperation has generated huge and real benefits for the United States... Since the outbreak of the international financial crisis, China has been supporting the efforts of the American people to tackle the crisis. On the one hand, China has increased imports from the U.S. While overall U.S. exports dropped 17.9 percent in 2009, exports to China hardly decreased. Many U.S. manufacturing firms have found comfort in the Chinese market as a shelter against the global financial storm. On the other hand, good value-for-money, labor-intensive goods imported from China have helped keep the cost of living down for Americans even when they become increasingly cash-strapped. Without consumer goods from China, the U.S. price index would go up an extra two percentage points every year... As Wen Jiabao, the Chinese premier, recently reiterated, it is always better to have a dialogue than a confrontation, cooperation than containment, and a partnership than a rivalry. As long as we approach the China-U.S. commercial relationship in a responsible manner we will definitely be able to make it more stable and sound." See Zhong Shan, "U.S.-China Trade Is Win-Win Game," *The Wall Street Journal*, 26 March 2010.

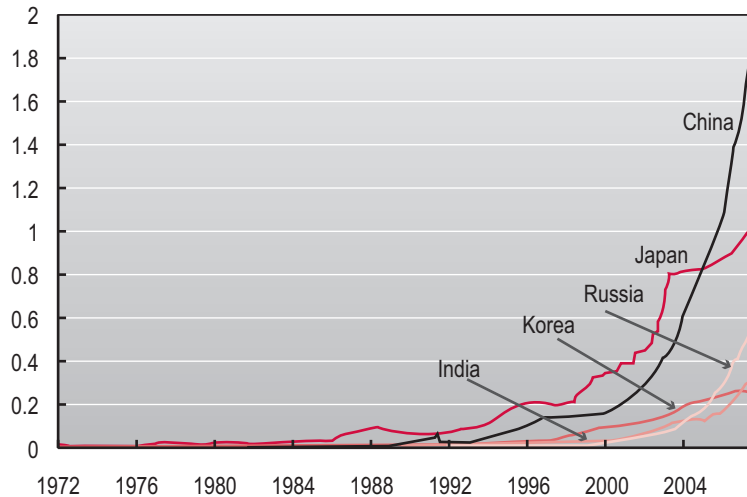
earlier statement denying that the *yuan* was undervalued or that China's exchange-rate policies were behind American deficits and the trade imbalance. Rather, Chen blamed restrictive US export policies, especially on high-tech dual-use goods such as supercomputers and satellites, for the US trade deficit problem. In similar vein, Vice Premier Wang Qishan has repeatedly stated that the United States trade deficit reflects a low US savings rate and profligate spending – a problem that even a moderate rise in the *yuan*'s exchange rate will not resolve. He urged the Obama administration to “take all necessary measures to stabilize its economy and financial markets to ensure the security of China's assets and investments in the US.” Most notably, Wang publicly lectured Geithner and other senior U.S. officials to take “credible steps” to protect the value of the dollar and that “high attention should be given to fiscal deficits.”<sup>(15)</sup> China, the biggest creditor nation to the United States, has every reason to be concerned about the potential inflationary impact of Washington's monetary and fiscal policies.

What to make of this heated tit-for-tat? Is it just rhetorical bluster or does it presage a widening of the fault-lines in Sino-US relations? If the latter is the case, what are the potential implications for Sino-US relations? A number of plausible and not-so plausible explanations have been advanced. For example, historian Niall Ferguson has unambiguously argued that Sino-US relations are poised to become increasingly confrontational and conflict-ridden – indeed, very much like the British-German geopolitical rivalry that led to the First World War.<sup>(16)</sup> In a similar vein, Nobel laureate Paul Krugman has argued that “China has become a major financial and trade power. But it doesn't act like other big economies. Instead, it follows a ‘mercantilist policy,’ keeping its trade surplus artificially high. And in today's depressed world, that policy is, to put it bluntly, predatory.”<sup>(17)</sup> Krugman proposes a rather provocative strategy arguing that “It's time to take a stand” and play “hardball” with China.<sup>(18)</sup> Similarly, Morici concludes that “diplomacy has failed, and President Obama should impose a tax on dollar *yuan* conversions in an amount equal to the amount of China currency market intervention divided by its exports – currently that would be about 28 percent. For imports, at least, that would offset Chinese subsidies that harm U.S. businesses and workers. Ultimately, the amount of the tax would be in China's hands. If Beijing reduced currency market intervention and let the *yuan* appreciate, the tax rate would fall. If Beijing stopped intervening, the tax would go to zero.... American failure to act would amount to no more than appeasement, and wholesale neglect of President

Obama's obligations to ensure U.S. economic security and sovereignty.”<sup>(19)</sup>

Yet, others warn that if the Obama administration adopts an uncompromisingly belligerent policy towards Beijing, it will incur painful economic costs. This is because the global economic landscape has fundamentally changed and the United States is no longer in a position to unilaterally call the shots. The new reality is that China is now officially the US government's largest foreign creditor, while America holds the distinction of being the world's largest debtor.<sup>(20)</sup> If history is any guide, creditors do not like to be lectured by their debtors, and of course can use their economic muscle to impose significant costs on debtors.<sup>(21)</sup> Some have even warned that it is not wise to get into Beijing's bad book. Rather, in order to get Chinese cooperation on a host of pressing issues, including Iran, North Korea, and trade and currency issues, the Obama administration should refrain from engaging in knee-jerk criticisms.<sup>(22)</sup> On the other hand, some analysts, most notably Drezner, remain more sceptical. They claim that Chinese power and leverage has been greatly exaggerated, and that Beijing's ability to exert financial leverage and coerce the United States is greatly circumscribed.<sup>(23)</sup> This paper straddles a broadly middle path between these competing viewpoints. It argues that on the one hand, China's growing economic power provides Beijing with a unprecedented policy autonomy – both the ability to resist pressure from others as well as to apply leverage against “wayward” sovereign debtors – very much like the unabashed powers the United States enjoyed in the early post-war period. On the other hand, China's deep and intimate

15. Kathy Wang, “Protect China's assets, US told,” *The Standard: China's Business Newspaper*, Friday, 5 December 2008, [http://www.thestandard.com.hk/news\\_print.asp?art\\_id=75364&sid=21758213](http://www.thestandard.com.hk/news_print.asp?art_id=75364&sid=21758213).
16. Niall Ferguson, “What ‘Chimerica’ Hath Wrought,” *The American Interest Online*, January-February 2009, <http://www.the-american-interest.com/article.cfm?piece=533>.
17. Paul Krugman, “Chinese New Year,” *The New York Times*, 1 January 2010; also see *The Economist*, “America's Fear of China,” 19 May 2007, and *The Economist*, “Mercantilism with Chinese Characteristics: China's Cheap Currency,” 12 August 2003.
18. Paul Krugman, “Taking on China,” *The New York Times*, 15 March 2010.
19. Peter Morici, “Trade Deficit, China's Currency Require U.S. Action Now,” 23 April 2010, <http://www.rhsmith.umd.edu/opinion/morici/2010/041310.aspx>.
20. For a good account of how the United States became the world's largest debtor, see William Cline, *The United States as a Debtor Nation*, Washington, DC, Institute for International Economics, 2005.
21. Brad Setser, *Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness*, New York, Council on Foreign Relations Press, 2008.
22. Gary Clyde Hufbauer, “Courting China,” *The National Interest*, no. 106, March-April 2010, pp. 10-15.
23. Daniel Drezner, “Bad Debts: Assessing China's Financial Influence in Great Power Politics,” *International Security*, vol. 34, no. 2, Fall 2009, pp. 7-45.

**Chart 1. Foreign Exchange Reserves (Trillions of U.S. dollars)**

Source: International Monetary Fund, *International Financial Statistics*.

economic integration in the global economic system, in particular the ever-expanding economic interdependence and convergence fostered via conspicuously wide-ranging trade, investment, and commercial ties between China and the United States, greatly constrains and circumscribes Beijing's ability to pressure, coerce, or punish the United States – despite the irresistible temptation. The fact that the US is China's largest market, and paradoxically, that China holds an estimated \$2.3 trillion in US assets, means that Beijing's economic fate is inextricably linked to the economic fortunes of its biggest debtor. This means that despite the frictions (punctuated with periods of intense acrimony) in their relations, the reality is that neither side is quite prepared to push the other beyond tacitly permissible limits, because for both countries, the overall current economic gains are unlikely to compensate for the enormous cost of conflict. Therefore, although the discord in Sino-US economic relations will not end anytime soon, it is important to put these recurrent wars-of-words in perspective. Specifically, this paper suggests that the current Sino-US economic disputes are really a form of intense policy dispute characterised by hard bargaining, and should not be exaggerated (as they usually are) with ominous sounding rhetorical adjectives such as “confrontations” and “geo-economic rivalry” with precipitous economic and security implications. However, this does not mean that these current and relatively benign relations should be taken for granted. On the contrary, the subprime-induced financial crisis has only exacerbated ongoing tensions in Sino-US economic relations; interdependence also has limits, especially as

the global economy heads into a prolonged period of “hard times.” The following sections will show that Beijing is concerned and has been working diligently to reduce its systemic dependence on its largest trading partner and debtor.

## The issues that divide

Before the subprime crisis broke, China was the world's largest holder of foreign cash reserves of roughly US\$2 trillion (Chart 1).

In fact, China had become the world's leading creditor nation (replacing Japan in 2003), while the United States is the world's largest debtor.<sup>(24)</sup> What explains how and why the world's once most prosperous and still the largest economy has become so structurally reliant on external financing – or more bluntly, what explains the decline of the United States to debtor status? In part, since the mid-1990s, the US Treasury has met its borrowing needs by purchasing debt from abroad. At the end of 1998, the foreign holdings of Treasury securities totalled about \$1.2 trillion (or roughly 37 percent of all debt held by the public); in 2008, the dollar value of foreign-owned debt had jumped to just over to \$2.9 trillion – or almost 50 percent of outstanding publicly held debt. The largest foreign holders of US debt are countries that run persistent trade surpluses with the United States.

24. Nouriel Roubini, “The Almighty Renminbi,” *The New York Times*, 14 May 2009; Xin Wang, “China as Net Creditor: An Indication of Strength or Weaknesses?”, *China and World Economy*, vol. 15, no. 6, December 2007, pp. 22-36; and Brad Setser, “China: Creditor to the Rich,” *China Security*, vol. 14, no. 4, Autumn 2008.

**Table 1. Major Foreign Holders of US Treasury Securities**

As of September 2008	\$ Billions	Percent of Debt Held by the Public
China	587.0	10.1
Japan	573.2	9.8
United Kingdom	338.3	5.8
Caribbean Banking Centres [1]	185.3	3.2
Oil Exporters [2]	182.1	3.1
Brazil	141.9	2.4
All Other	852.9	14.6
<b>Total</b>	<b>2,860.7</b>	<b>49.0</b>

**Notes:** 1. Caribbean banking centres include Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama and British Virgin Islands.

2. Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya and Nigeria.

**Source:** US Treasury, Treasury Bulletin, 2009, Table OFS-1.

Until September 2008, Japan was the largest holder of Treasury debt, only to be replaced by the Chinese, whose holdings of Treasury debt skyrocketed from about \$46 billion in 1998 to \$587 billion by 2008 (Table 1).<sup>(25)</sup> However, China's real holdings are estimated to be over \$800 billion, as China also purchases through third countries US debt that is not recorded by the Treasury as being held by China.<sup>(26)</sup> This means that Beijing is not only the largest foreign holder of US government debt (as it now owns \$1 out of every \$10 in US public debt), but it is also in effect the US government's largest creditor. Indeed, Washington has become increasingly dependent on Beijing to raise money to cover its ever-growing list of expenditures, including paying for the current stimulus and bailout programs.<sup>(27)</sup>

To many American policymakers this is an ominous sign, because America's growing dependence and Beijing's growing financial leverage as a creditor grants it extraordinary influence over the US economy. If for economic or strategic reasons Beijing decided to move out of US government bonds, it would force other investors to do the same, and in the process drive up the cost of US borrowing and undermine Washington's ability to manage the nation's economy. Similarly, if China stopped buying, or worse, began selling US debt, it would sharply raise interest rates on a variety of loans in the US.<sup>(28)</sup>

To the United States, the origins and persistence of its massive trade deficit with China is due to Beijing's mercantilist economic policies (see Tables 2 and 3). The US contention regarding China's mercantile behaviour is rather straightforward: Beijing engages in gratuitously unfair trade practices via outright

protectionism, and most perniciously, by deliberately manipulating its currency. Specifically, in maintaining an undervalued exchange rate, Beijing has been able to dramatically increase its export growth and pile up large current account surpluses – the latter by aggressively intervening in foreign exchange markets to keep its currency from appreciating. This in turn has resulted in a massive build-up of foreign exchange reserves.<sup>(29)</sup> However, if Beijing allowed market forces to determine the value of its currency, its current account surpluses would be much lower, and American trade balances much healthier.<sup>(30)</sup>

Not surprisingly, American manufacturers, with the backing of lawmakers in Congress, have long argued that the artificially low *yuan* has placed American companies at a huge competitive disadvantage, *inter alia* contributing to the bankruptcy of US companies and the loss of tens of thousands of

25. Office of Management and Budget, Mid-Session Review, Budget of the US Government, Fiscal Year 2009, July 2008, <http://www.whitehouse.gov/omb/budget/fy2009/pdf/09msr.pdf>.

26. Brad Setser, "Impact of China Investment Corporation on the Management of China's Foreign Assets," in Morris Goldstein and Nicholas Lardy (eds.), *Debating China's Exchange Rate Policy*, Washington, DC, The Peterson Institute, 2008, pp. 201-18.

27. Also see Brad Setser and Arpana Pandey, "China's \$1.5 Trillion Bet: Understanding China's External Portfolio," Working Paper, New York, Center for Geoeconomic Studies, Council on Foreign Relations, May 2009.

28. Brad Setser, *Sovereign Wealth and Sovereign Power: The Strategic Consequences of American Indebtedness*, New York, Council on Foreign Relations Press, 2008; also see Matthew Burrows and Jennifer Harris, "Revisiting the Future: Geopolitical Effects of the Financial Crisis," *Washington Quarterly*, vol. 32, no. 2, April 2009, pp. 27-38.

29. Morris Goldstein and Nicholas Lardy, "China's Role in the Revived Bretton Woods System: A Case of Mistaken Identity," Working Paper 05-2, Washington, DC, Peterson Institute for International Economics, 2005.

30. Wayne M. Morrison and Marc Labonte, *China's Currency: A Summary of the Economic Issues*, Congressional Research Service, 13 April 2009, no. RS21625, Washington, DC.

**Table 2. US Merchandise Trade with China: 1980-2007 (\$ in billions)**

Year	US Exports	US Imports	US Trade Balance
1980	3.8	1.1	2.7
1985	3.9	3.9	0
1990	4.8	15.2	-10.4
1995	11.7	45.6	-33.8
2000	16.3	100.1	-83.8
2001	19.2	102.3	-83.1
2002	22.1	125.2	-103.1
2003	28.4	152.4	-124.0
2004	34.7	196.7	-162.0
2005	41.8	243.5	-201.6
2006	55.2	287.8	-232.5
2007	65.2	321.5	-256.3

Source: US Congressional Research Service (2008, p.2)<sup>(31)</sup>

American jobs.<sup>(32)</sup> The contention is that the *yuan* is so undervalued (by some accounts as much as 40 percent) that it amounts to an unfair trade subsidy. This unfair advantage permits a flood of cheap Chinese-made goods into the United States, but makes American products expensive in China.<sup>(33)</sup> Thus it is claimed that if the *yuan* were traded at its true market worth the bilateral imbalance between the two countries would be substantially reduced, if not altogether eliminated. This is because China's exports to the United States would become more expensive in dollars and would therefore decrease, while China's imports from the US would become less expensive in *yuan* and therefore increase. To make matters worse, China's unwillingness to allow the *yuan* to appreciate has, in turn, made other Asian Pacific Rim countries reluctant to allow their currencies to appreciate because of their fear of losing further export sales to China.<sup>(34)</sup> As the US trade deficit with China soared to record levels in first-quarter 2005, the Bush administration came under intense pressure to take unilateral action to address the problems associated with the artificial undervaluation of the *yuan*. US Treasury Secretary John Snow called for an immediate Chinese exchange rate adjustment, but many other lawmakers called for punitive tariffs on cheaply priced Chinese imports unless China sharply revalued its currency.

In May 2005, the US Senate by a margin of 67 to 33 voted to consider a proposal to impose a 27.5 percent tariff on all

imports from China unless Beijing stopped inflating its currency. In May 2005, the US decided to re-impose quotas on seven categories of clothing imports from China, limiting their growth to no more than 7.5 percent over a 12-month period. On 23 June 2005, the Bush administration, which

31. Full source: Wayne M. Morrison, *CRS Report for Congress: China-U.S. Trade Issues*, Order Code 33536, Washington, DC, Congressional Research Service, 7 March 2008.
32. From its peak in early 1998, the United States has lost over 3.3 million manufacturing jobs. While not all of the job loss can be attributed to China, the US manufacturing sector, despite significant productivity growth, could not overcome the huge trade advantage China gained by having an undervalued currency. The decline in manufacturing employment has led both Democratic and Republican senators to threaten the Chinese with substantial tariffs on Chinese imports to offset the Chinese currency advantage. For details, see Gary Clyde Hufbauer and Yee Wong, "China Bashing," *International Economics Policy Briefs*, no. PB04-5, Washington, DC, Institute for International Economics, 2004.
33. Some economists claim the *yuan* is anywhere from 15 percent to 40 percent undervalued against the dollar, making Chinese exports to the United States cheaper and contributing to China's trade surplus with the United States. Of course, no one really knows the true extent of the undervaluation. This is because not letting the market decide a currency's value means the nominal exchange rate – literally the number of units of one currency you can get for one unit of another – is essentially made up. It is whatever the government chooses it to be, so long as the regime can be feasibly maintained. For a good overview, see Nicholas Lardy, "China: The Great New Economic Challenge," in C. Fred Bergsten (ed.), *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington, DC, Institute for International Economics, 2005; Arvind Subramanian, "New PPP-Based Estimates of Renminbi Undervaluation and Policy Implications," *Policy Brief*, no. PB10-8, April 2010, Washington, DC, Peterson Institute for International Economics; and Anthony J. Makin, "Does China's Huge External Surplus Imply an Undervalued Renminbi," *China and the World Economy*, vol. 15, no. 3, 2007, pp. 89-102.
34. Indeed, following the Chinese revaluation, Malaysia responded by shifting its own currency regime from a dollar peg to a basket peg. However, given the very small initial change in the *yuan's* value, most countries in the region seems to be waiting for a more substantial *yuan* revaluation before taking action.

**Table 3. US Merchandise Trade Balances with Major Trading Partners: 2007 (\$ in billions)**

Country / Trading Group	US Trade Balance
World	-791.0
China	-256.3
Organization of Petroleum Exporting Countries (OPEC)	-127.4
European Union (EU27)	-107.4
Japan	-82.8
Mexico	-74.3
Canada	-64.7
Association of Southeast Asian Nations (ASEAN)	-50.6

Source: US Congressional Research Service (2008, p.2)<sup>(31)</sup>

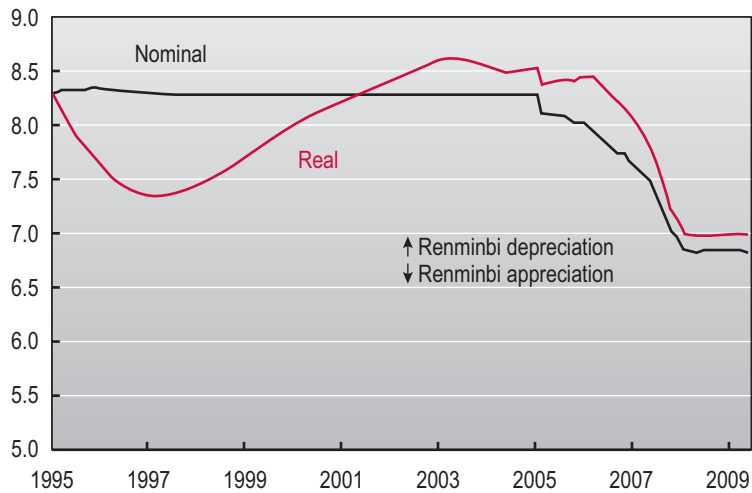
until then had insisted that diplomacy was working in getting China to allow the *yuan's* value to be set by currency markets rather than be controlled by the government, finally warned China that it could be cited as a “currency manipulator” and face economic sanctions unless it switched to a flexible exchange system. Labelling China’s currency policies “highly distortionary,” the Bush administration warned that it was going to closely monitor China’s progress towards adopting a flexible exchange system.

It seems that the pressure worked. On 21 July 2005, Beijing made its biggest monetary shift in more than a decade by revaluing the *yuan* and dropping the currency’s peg to the US dollar by announcing that the *yuan's* exchange rate would become “adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket” composed of the dollar, the yen, and the euro, along with a few other key currencies.<sup>(35)</sup> This was an important, albeit modest shift. From 1994 to July 2005, the value of the *yuan* was pegged to the US dollar at a rate determined by the People’s Bank of China. The *yuan* traded within the range of 8.27 to 8.28 to the dollar because the People’s Bank maintained this peg by buying dollar-denominated assets in exchange for the *yuan* in order to reduce excess demand for the *yuan*. As a result, the exchange rate between the *yuan* and the dollar remained largely the same – despite changing market conditions. When Beijing abandoned the peg by moving to a system that now linked the *yuan* to a basket of currencies, it effectively raised the *yuan's* value by 2.1 percent.<sup>(36)</sup> This meant that prior to the revaluation, US\$1 bought 8.28 *yuan*, and following revaluation US\$1 would buy roughly 8.11 *yuan*. Beijing made it clear that it had set tight parameters on how much the *yuan* could

rise. Clearly, the aim was to make sure that the *yuan* did not float by a big margin, but appreciated<sup>(37)</sup> by a modest 2 percent by moving within a tight range of a 0.3 percent band against a group of foreign currencies that make up China’s top trading partners.<sup>(38)</sup> Thus, unlike a true floating exchange rate, the *yuan* was allowed to fluctuate by only 0.3 percent on a daily basis against the basket. However, this modest and gradual appreciation (called “managed float”) allowed China to continue to accumulate foreign reserves – implying that if the *yuan* was allowed to free float, it would appreciate much more rapidly. The fact that from July 2005 to May 2008 the *yuan* appreciated by 14.4 percent in terms of the US dollar – but much less in real effective terms (since most other major currencies have appreciated against the dollar) – despite China’s large and growing trade surpluses, barely managed to placate critics. However, as noted earlier, when

35. Revaluation is the resetting of the fixed value of a currency at a higher level.
36. Both flexible and floating exchange rates have distinct advantages – albeit, no single exchange rate regime is appropriate for all countries in all circumstances. A fixed exchange rate that pegs the value of a currency to a stronger foreign currency like the US dollar or the euro has advantages for developing countries seeking to build confidence in their economic policies. On the other hand, countries with fixed exchange rates are seemingly more vulnerable to currency crises. As economies mature and become more closely aligned with the international financial markets, exchange rate flexibility seems more advantageous.
37. When a currency increases in value, it experiences appreciation. When it falls in value and is worth fewer US dollars, it undergoes depreciation. Thus, when a country’s currency appreciates (rises in value relative to other currencies), the country’s goods abroad become more expensive, and foreign goods in that country become cheaper. Conversely, when a country’s currency depreciates, its goods abroad become cheaper, and foreign goods in that country become more expensive.
38. Both the Central Bank Governor Zhou Xiaochuan and Premier Wen Jiabao noted that the revaluation should be viewed as the first in what is expected to be a series of steps over years to shift the *yuan* toward even greater flexibility as China increases its participation in the world trading system. See People’s Bank of China, “Public Announcement of the People’s Bank of China on Reforming the RMB Exchange Rate Regime,” 21 July 2005, <http://www.pbc.gov.cn/english/detail.asp?col=6500&id=82>.



**Chart 2. Renminbi-Dollar Exchange Rate (Renminbi per U.S. dollar)<sup>(39)</sup>**

Source: International Monetary Fund, *International Financial Statistics*.

Beijing in 2008 resumed its earlier practice of pegging the *renminbi* to revive its faltering export-dependent economy (chart 2), the gloves came-off.

## The ties that bind

Although few will dispute that the dramatic expansion of Beijing's economic influence over the American economy is not healthy, what is not always appreciated is that economic interdependence also generates countervailing forces that tend to push towards a more balanced equilibrium. For example, on the one hand, China purchases US bonds (which are denominated in dollars) to make the dollar stronger against the *yuan* as an artificially weak *yuan* helps to boost Chinese exports, in addition to making Chinese exports cheaper relative to US exports.<sup>(40)</sup> On the other, growing Chinese investment in the United States has helped bring down interest rates, as well as assisting in the financing of the \$1 trillion annual US deficit – and the US government's current massive bailout of its financial system. Also, as Krugman and others are fond of repeating, China needs the United States more than the United States needs China, because when the debts become too massive, there are always more risks for the creditor. In other words, underscoring the old adage that “If you owe the bank a thousand dollars you worry, but if you owe the bank a million dollars, the bank worries,” China's growing financial clout is also profoundly limited by its major debtor – the United States. Beijing not only depends on a strong dollar to keep its export engines

humming, it has also put itself in the unenviable position where it has to literally defend the dollar value.

In fact, reminiscent of Japan, which also had the bulk of its foreign assets denominated in US dollars rather than yen, and then saw the value of those assets drop when the US dollar depreciated sharply following the Plaza Accords in 1985, China today faces the same risks – and more. China is often referred to as an “immature creditor” because it does not lend in its own currency, but in the currency issued by borrower (the loans China makes are denominated in US dollars); it is therefore exposed to exchange rate risks as the value of the debt fluctuates with the dollar's rise and fall. Since an unprecedented 80 percent of China's reserves are estimated to be in dollars, even a modest depreciation of the dollar will translate into significant losses for Beijing. Martin Feldstein captures this irony lucidly when he notes, “Consider what a decline of the dollar relative to the *yuan* would mean for the Chinese. If the Chinese now hold \$1 trillion in their official portfolios, a 10 percent rise in the *yuan*-dollar exchange rate would lower the *yuan* value of those holdings by 10 percent.”<sup>(41)</sup> As a result, China has great incentive to defend the US dollar – and the fastest and easiest way to do this is to buy even more Treasury bonds. Indeed,

39. Chart 2 downloaded from Owen F. Humpage and Caroline Herrell, “Renminbi-Dollar Peg Once Again,” *Economic Trends*, Federal Reserve Bank of Cleveland, 25 November 2009.

40. Geoff Dyer, “China's Dollar Dilemma,” *Financial Times*, 22 February, 2009; Paul Krugman, “China's Dollar Trap,” *The New York Times*, 3 April 2009; David Leonhardt, “The China Puzzle,” *The New York Times Magazine*, 17 May 2009.

41. Martin Feldstein, “How Safe Are Your Dollars?,” *Project Syndicate*, 25 February 2010, <http://www.project-syndicate.org/commentary/feldstein20/English>.

a few years ago, Ronald McKinnon boldly predicted that Beijing would maintain its informal dollar peg and continue to accumulate dollar reserves as long as the dollar remains a useful monetary anchor – which he claims is indefinitely.<sup>(42)</sup> This also means that the argument that Beijing can punish the United States by dumping its holdings of Treasury debt (the resulting market disruption would lead to higher US interest rates and a collapse of the dollar on foreign exchange markets) is not compelling. The Congressional Research Service has persuasively argued that such a sudden and highly disruptive strategy is not in the cards because it is unlikely to be effective.<sup>(43)</sup> This is because even the largest foreign holdings of US government debt are smaller than the daily volume of trade in Treasury securities. If the Chinese did employ such a strategy, the resulting decline in the value of US Treasury securities would generate substantial losses to all debt holders, including those attempting to use their debt holdings as leverage. Similarly, Beijing's repeated call (if not subtle "threat") for the creation of a new international reserve currency, the use of IMF's SDR, and to make the *renminbi* an international alternative to the US dollar, is not credible. Indeed, there is little danger that the dollar will be replaced as the world's dominant foreign exchange reserve anytime soon. For starters, before the *yuan* can be brought into competition with the dollar as a medium of international trade, it must be first made into a convertible currency whose value is determined by the market. Beijing simply cannot allow this, as it would not only mean loss of control by the Party-state, but also that China would have to lower or remove all manner of financial and trade barriers – which it is not prepared to do. Regarding SDRs: although a country can convert its reserves into SDRs, this does not mean that the SDRs can automatically function as an international currency. Specifically, until the private sector adopts SDRs, countries that adopt the SDRs will still need to acquire dollars or euros or some other national currency to spend their reserves. Suffice it to note that the private sector will only adopt the SDR if it provides tangible benefits – something it does not do at the moment.

Despite its bold claims, Beijing also realises this. The reality is that even while the dollar's weakness undermines the value of China's existing reserves, Beijing really has no interest in exacerbating or precipitating a crisis by moving out of dollar assets. In other words, although there is nothing to prevent China from diversifying its reserves away from the dollar, such an action is not without risk. Given the fact that China now owns so many dollars, any massive sell-off will also push the dollar down with huge losses on China's dol-

lar-denominated assets. Not surprisingly, as if to calm the nervous currency markets, Central Bank Governor Zhou had to quickly reverse his statement by announcing that China would continue to buy Treasuries. In fact, the day after Zhou called for the new reserve currency, China's influential State Administration of Foreign Exchange issued a statement that it supported the dollar and would continue to buy US Treasuries.

Moreover, the sheer size of the US share of the world economy (27.5 percent in 2006), and the world's seemingly insatiable appetite for dollar-denominated assets means that the economic law of gravity does not necessarily apply to the US. After all, the US dollar is the world's reserve currency. A large portion of international payments are made in dollars, and a substantial portion of international trade (even trade not directly involving the United States) is denominated in US dollars. In addition, globally traded commodities (such as oil and food grains) are priced in dollars. Thus, foreign banks hold portfolios of dollar assets and liabilities. Overall, some two-thirds of the world's official foreign exchange reserves of \$6.7 trillion are held in dollars. This means that central banks around the world not only hold more US dollars and dollar securities than they do assets denominated in any other foreign currency, they also know that these dollar reserves are essential to stabilising the value of their own national currencies. Indeed, the prevailing assumption that if the American economy went into a sharp downturn, foreign central banks would be reluctant to invest their national savings into the dollar has so far proven to be incorrect. Rather, the dollar has once again been affirmed as the global reserve currency. The massive "flight to safety" into US Treasury by panicked investors following the collapse of Lehman Brothers only underscores that the US government is still the safest investment in the world, and that for all their flaws, the US dollar and dollar-denominated assets are today akin to what gold was during the Bretton Woods era.

The oft-mentioned phrase that China is the "world's factory" is both a blessing and a curse. China is not only the world's largest exporter of manufactured products, but also a major exporter of agricultural commodities and other raw materials. This means that the Chinese economy is structurally dependent on exports. China's share of merchandise exports increased from about \$10 billion in the late 1970s to

42. Ronald McKinnon, *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, Cambridge, MA, The MIT Press, 2005.

43. Wayne M. Morrison and Marc Labonte, "China's Holdings of U.S. Securities: Implications for the U.S. Economy," Congressional Research Service, Order Code RL34314, 19 May 2008, <http://www.fas.org/sgp/crs/row/RL34314.pdf>.

\$326 billion in 2002. More precisely, China's total share in world trade expanded from 1 percent in 1980 to about 6 percent in 2004.<sup>(44)</sup> In 2004, China's merchandise trade with the world totalled around \$1.3 trillion – the result of annual growth rates above 30 percent in some years. By the end of 2004, China had become the third-largest trading nation in dollar terms, behind the United States and Germany and just ahead of Japan.<sup>(45)</sup> By 2008, net exports (or the trade-balance surplus) were about 12 percent of GDP (up from 2 percent earlier in the decade), and exports represented about 40 percent of China's GDP. Overall, with the sum of exports and investment representing about 80 percent of GDP, China's aggregate demand depends on its ability to sustain export-based economic growth. Thus, Beijing has an enormous stake in the smooth expansion of global commerce and in upholding the global economic order.

Finally, China's policy-makers are a pragmatic lot and are hardly interested in precipitating a potentially ugly and protracted trade war with its major trading partner. They are cognizant of the fact that their country's rapid rise as a global creditor at such an early stage of economic development also reflects an inherent weakness in the Chinese economy. There are two core aspects to this. First is the constant need by China to expand its current account surplus. That is, although Japan became a major creditor following the sharp appreciation of the yen and accompanying monetary easing following the Plaza Accord of 1985 (giving rise to excess liquidity), Japan (unlike China) is also a major industrial power with relatively strong economic fundamentals. On the other hand, China's net foreign asset (NFA) position (or the difference between external assets and liabilities) has only swung from net debtor status to net creditor status over the past decade. Although China's NFA position exceeded 30 percent of GDP by 2007, its per capita GDP was still only \$2,500 – or less than one tenth of the OECD average. This means that China's rapidly growing NFA position since the beginning of 2000 is mainly the result of its burgeoning current account surplus, complemented by the high domestic savings rate relative to its high domestic investment rate. This savings-investment gap could pose a serious problem if the current account continues to weaken.

Second, the paradox: What explains why China, still a very poor country in terms of GDP per capita (China's GDP per capita ranks around 100th in the world) and relative scarcity of capital, is now a global creditor and exporter of capital to the world's richest nation? In other words, why is China subsidising the world's richest country? Beijing understands that the problem, in part, is reflective of China's deeply-rooted

institutional and structural weaknesses. China's woefully underdeveloped capital markets, a weak (and fragile) banking sector, two highly speculative stock markets, a rudimentary government bond market, poor resource allocation, and a non-existent social security system prevent effective utilisation and investment of the country's national savings. China must effectively address its many domestic economic problems, including restructuring bank balance sheets, strengthening domestic capital markets, creating foreign-exchange hedging instruments, and improving corporate governance, among other things, to overcome the domestic constraints to prudent investments. While these processes have begun in some sectors, it will take time. Beijing is well aware that at present there are few viable alternatives to US dollar holdings. Yet, they also know that China must fundamentally deepen economic reforms and allow market forces to play a decisive role in resource allocation, including modernising and opening the domestic financial markets to better mediate the nation's wealth.<sup>(46)</sup> In the meantime, Beijing must heed Deng Xiaoping's sage admonition and "bide its time" to facilitate its "peaceful rise."

## Loosening the ties of interdependence

Of course, economic interdependence and convergence does not necessarily mean absence of conflict. After all, the gains of interdependence are not always aligned in a perfect equilibrium. As Sino-US economic relations have become disproportionately one-sided (at least in terms of trade and surplus), acrimony and discord have intensified. Apparently, anticipating a more adversarial or "hardball" US position, Beijing is reassessing its economic relations with the United States – with an eye on reducing its dependence. There are a number of possible scenarios. At the extreme, intense pressure by the United States could force a beleaguered Bei-

44. For details see, Shalendra D. Sharma, *China and India in the Age of Globalization*, New York, Cambridge University Press, 2009.

45. Data compiled from OECD, *OECD Economic Survey: China*, Paris, Organization for Economic Cooperation and Development, September 2005; and International Monetary Fund (IMF), *World Economic Outlook 2007*, Washington, DC, International Monetary Fund, 2007; and World Bank, *China Quarterly Update* (various issues), Permanent URL: <http://go.worldbank.org/NZLENK2LKO>. Also, according to Lardy, between 1978 and the end of 2003, foreign firms invested about US\$500 billion in China and accounted for over one-quarter of China's output of manufactured goods. In 2004, China attracted some US\$60.6 billion of FDI. Only the United States with nearly US\$96 billion and UK with US\$78 billion received more. See Nicholas R. Lardy, "China: Toward a Consumption-Driven Growth Path," *Policy Brief*, no. PBO6-6, Washington, DC, Institute for International Economics, October 2006.

46. Xin Wang, "China as a Net Creditor: An Indication of Strength or Weaknesses?", *China and the World Economy*, vol. 15, no. 6, 2007, pp. 22-36.

jing to retaliate. For example, declaring China a “currency manipulator” and imposing punitive measures could push Beijing to liquidate some of its US Treasury bonds. Contrary to conventional belief, this would not be as difficult as one thinks. After all, not only are China’s foreign assets held as “official” foreign exchange reserves, but the Chinese party-state has a pervasive command over the economy via its control of the banking sector. It can act quickly and decisively. Moreover, in contrast to Japan, China does not have to be deferential (or more aptly *kowtow*) to the United States. Despite being a creditor, Japan, a member of the western alliance and beneficiary of the American security umbrella, was under American tutelage and “indebted” to its major debtor. However, China, a competitor to American power and influence, and whose relations with its major debtor can best be described as a “marriage of convenience,” has a freer hand to utilise its economic leverage as a tool of foreign policy. Beijing’s actions would no doubt inflict much pain on investors in US Treasury debt – both foreign and domestic. China will be a big loser (a case of cutting its nose to spite its face), but investors would also lose faith in the ability of the US government to meet its obligations in the face of unsustainable, long-term structural deficits. To reiterate, since the lion’s share of China’s foreign exchange reserves are invested in US Treasury securities (this has helped keep down interest rates in the United States despite chronic budget deficits and weak domestic savings), any significant changes in China’s management of its foreign exchange could have a profoundly negative impact in the American securities markets.

Of course, Beijing would prefer to reduce its dependence in a more measured and gradual manner. In fact, Beijing has been seriously examining its options regarding the cost of maintaining the dollar-based system. It is rightfully concerned that the exploding US government deficit has a real potential to lead to inflation and sharply reduce the purchasing power of its dollar-denominated financial assets. As a hedge against this, Beijing has been contemplating and experimenting with a number of strategies, including short-term arrangements to diversify its investment portfolios away from US dollars. On this issue, China is hardly alone. Both Russia and India have also called for an end to the dollar’s dominance in the international monetary system. Russian President Dmitry Medvedev on several occasions has noted that the dollar system is “flawed” and that a new supranational currency should be created. Similarly, a senior economic adviser to Indian Prime Minister Manmohan Singh has urged the government to diversify its \$264.6 billion for-

eign-exchange reserves (2008 figures) and hold fewer dollars. Like China, both have claimed that world currencies need to adjust to help unwind trade imbalances that contributed to the global financial crisis.

However, unlike Russia and India, China is not waiting. In 2009, Beijing signed currency swap agreements totalling about 650 billion *yuan* (or about US\$95 billion) with Hong Kong, Argentina, Indonesia, South Korea, Malaysia, and Belarus. This will now allow these countries to settle accounts with China using the *yuan* rather than the dollar. In July 2009, the People’s Bank took another step towards internationalising its currency and reducing reliance on the US dollar with the announcement of new rules to allow select companies to invoice and settle trade transactions in *renminbi* through financial institutions in Shanghai, Hong Kong, and Macao. This means that importers and exporters will now be able to place their orders with approved Chinese companies and settle payment in *renminbi*. In addition, Hong Kong banks will now be allowed to issue *yuan*-denominated bonds – a step towards building an offshore *yuan* market, while foreign banks will be allowed to buy or borrow *yuan* from mainland lenders to finance such trade. While the central bank has averred that this does not mean full convertibility of the *renminbi*, but is only meant to provide stability for local exporters hard hit by the dollar’s widely fluctuating value, it does underscore Beijing’s growing concern about the future of the green-back and is in line with its ambition to make the *yuan* an internationally traded currency. In the meantime, China continues to be a significant net buyer of US bonds, mainly Treasuries.

Contrary to conventional wisdom, bitter historical legacies are not necessarily a barrier to deep economic cooperation. Despite their painful recent past, China, Japan, and South Korea (the region’s three biggest economies) have formed an ambitious “united front” to counter the adverse effects of global financial turmoil. On 13 December 2008, the leaders of the three nations held their first-ever summit in Japan. The summit signalled an unprecedented phase of cooperation between the three nations, with Japan and China expanding credit lines for currency agreements with South Korea to strengthen the *won*. Again, on 23 February 2009, against the backdrop of the deepening financial crisis, the Finance Ministers from China, Japan, South Korea, and ten Southeast Asian nations agreed to create a US\$120 billion pool of foreign-exchange reserves to be used by countries to defend their currencies from speculative attacks. The agreement significantly broadens the earlier arrangement called the “Chiang Mai Initiative” (which only allows bilateral cur-

rency swaps)<sup>(47)</sup> by functioning as a *de facto* system of regional macroeconomic monitoring and cooperation.<sup>(48)</sup> In a joint statement, Chinese Premier Wen, Japanese Prime Minister Taro Aso, and South Korean President Lee Myung-Bak also vowed to boost regional trade and investment. Their communiqué reaffirmed the importance of close regional cooperation to counter the financial crisis. On 24 March 2010, the Chiang Mai Initiative Multilateralization (CMIM) formally came into effect. The body's responsibilities include monitoring the economic and financial status of ASEAN+3 countries (Association of Southeast Asian Nations, plus China, Japan, and South Korea) and providing guidelines regarding the use of the foreign currency reserve pool. In addition, the ASEAN+3 countries also agreed to create a regional credit guarantee and investment fund with an initial grant of \$700 million to promote the issuance of bonds in domestic currencies within the region. Clearly, China is increasingly looking beyond the United States.

China has also been actively engaged in "strategic economic expansion."<sup>(49)</sup> Specifically, Beijing has become an active participant in the international markets for mergers and acquisitions (M&A). Its gross foreign holdings acquired through M&As, "basically nonexistent 20 years ago, reached over \$87 billion by the end of 2008... two main types of foreign direct investment are 'greenfield,' in which a company builds a plant in a target country, and direct investment through mergers and acquisitions, in which a company purchases a large stake in an existing foreign firm."<sup>(50)</sup> More significantly, Beijing has been transferring part of the nation's wealth into "sovereign wealth funds." Since 2007, Beijing has allocated some \$200 billion into a sovereign wealth fund under the management of the government-sponsored China Investment Corporation (CIC) to be used for investment abroad. It is the largest state-owned fund in the world. This financial power provides Beijing with a unique opportunity to extend its global reach by enhancing its ability to purchase or gain major ownership stakes in businesses, financial institutions, resources, and technology. One of the first announced investments of CIC was a 10 percent stake in the US-based private equity firm Blackstone Group. Although this raised concern on Wall Street at the prospect of "growing Chinese influence" on US corporate operations through the stock market, Washington could do little to stop it. As a large investor in US Treasuries, China claimed that it was simply trying to earn a higher return on its foreign investments by dividing its assets into stocks, bonds, and commodities such as oil and gold. This trend will continue. Chinese financial institutions have come under in-

tense criticism at home for bad investments in the United States, including the \$5.6 billion share in Morgan Stanley purchased by the China Investment Corporation and the large paper losses on the \$3 billion CIC invested in Blackstone Group in June 2007. As a result, Beijing's top priority is to broaden investments and reduce risk – which at its heart is a reduction in the purchase of US Treasuries. Not surprisingly, China, a large foreign investor in bonds from Fannie Mae and Freddie Mac, has been sharply reducing its holdings of that debt. After making direct net purchases of \$46 billion in the first half of 2008, Beijing was a net seller of \$26.1 billion in the second half of 2008. In fact, it was weak demand from China and other foreign investors that led the US Federal Reserve to announce in November 2008 that it would buy up to \$600 billion in debt from Fannie, Freddie, and other US government-related mortgage companies.

Beijing also realises that its attempt to paint itself as a helpless victim of the US dollar is losing traction and sounds increasingly disingenuous. The charge by Krugman and others that China's problems are fundamentally rooted in its deliberate strategy of "mercantilism" has now stuck. Arguably more importantly, the subprime crisis has finally forced Beijing to rethink its currency's close links to the US dollar. Although the exponential growth of China's massive foreign-exchange reserves has been the result of trying to sustain a stable exchange rate between the *yuan* and the dollar – even in the face of strong economic pressures for appreciation (given China's strong productivity growth, it is natural for the *yuan* to appreciate), this linkage is becoming increasingly burdensome. To prevent appreciation and avoid loss of export competitiveness, the People's Bank has been forced to aggressively buy dollars and sell *renminbi*. However, this strategy has not been without pain. Besides making domestic macroeconomic management difficult (China's controls on private exchanges of *renminbi* for other currencies are not always effective), concentration on exchange-rate stabilisation has meant that Beijing has largely ceded the ability to use monetary policy to target domestic objectives such as

47. The Chiang Mai Initiative was initially set up as a set of bilateral currency swap lines in the wake of the Asian crisis. Specifically, the initiative was designed to prevent another sudden run on financial assets such as the one that wreaked havoc on Asian economies in the late 1990s.

48. Of course, China's contribution of \$38.4 billion to the fund was made in US dollars, as its own currency is not fully convertible.

49. Huaichuan Rui and George S. Yip, "Foreign Acquisitions by Chinese Firms: A Strategic Intent Perspective," *Journal of World Business*, vol. 43, 2008, pp. 213-226.

50. Titan Alon, Galina Hale, and Joao Santos, "What is China's Capital Seeking in a Global Environment?," *FRBSF Economic Letter*, San Francisco, Federal Reserve Bank of San Francisco, 22 March 2010.

controlling inflation. Consequently, the continuous depreciation of the US dollar has not only increased uncertainties associated with capital movement, but also exerts the pressure of imported inflation on China by driving up commodities prices in dollar terms. The sharp hike in food prices in recent years has already eroded the gains made in economic development, especially poverty reduction. Moreover, the subprime-induced general tightening of the global credit markets and the resultant "credit crunch" has reduced capital flows into China. Over the short term this may not be a serious problem, as China has a fair amount of liquidity in the domestic economy. However, if the problem persists over time, the credit crunch could have a negative impact. For example, an impact on the business sector's ability to raise funds from international sources can impede investment growth, as these businesses would have to rely more on costlier domestic sources of financing, including bank credit. This could in turn put further upward pressure on domestic interest rates.

Beijing is aware that it would be more prudent to adopt a more flexible exchange rate. After all, China's emphasis on exchange rate stability in the face of rising current account surpluses has not only generated intense protectionist pressures in the United States and elsewhere, but has also forced the central bank to accumulate massive foreign exchange reserves with negative domestic consequences. Keeping the *yuan* from rising against the dollar not only means that China's central bank has to print more money to keep interest rates low, as noted, but could also exacerbate the problem of inflation if more money ends up chasing too few goods. It also means that China is exposed to large capital losses on its foreign reserve holdings (which, again as noted, are largely held in US dollars) as the *renminbi* appreciates. Moreover, an appreciation of the exchange rate would also boost domestic consumption – something China needs. The adoption of a flexible exchange rate would give China greater leverage to limit deviations of inflation and growth from chosen targets by means of a monetary policy focused on domestic objectives. Of course, such a policy does not imply totally ignoring the exchange rate, as it may require the authorities to intervene in the exchange market to limit short-run currency fluctuations. Nor does it mean that a move towards a more flexible rate is an argument for capital account liberalisation. Suffice it to say there are numerous cases of countries operating managed floats while maintaining capital controls. Rather, the adoption of a monetary policy aimed at domestic objectives would help China develop a more balanced and resilient financial system.

Finally, facing growing protectionist pressures from the US and elsewhere, China now appreciates more the upside of reducing its reliance on exports as a main growth engine by strengthening domestic demand. On 11 November 2008, Beijing approved a massive 4 trillion *yuan* (\$586 billion) stimulus package over two years. Totalling some 14 percent of annual GDP, it is arguably the biggest peacetime stimulus ever.<sup>(51)</sup> The package has ten targeted spending items, including construction and rural infrastructure, as well as more "harmonious growth" via increased investment in the public health care system, education, subsidised housing, and increases in unemployment and other welfare benefits. Since the political legitimacy of the Communist Party rests on continuing to deliver high economic growth, the subprime crisis, especially Beijing's decision to put so much of the nation's hard-earned savings in low-yield dollar-denominated bonds (despite the growing needs at home) has generated widespread public anger. According to Martin Feldstein, "The value of the dollar portfolio is equal to about \$1,000 per person in China, about the level of the total per capita income in China at the official exchange rate."<sup>(52)</sup> Arguably, popular resentment against the Party-elite, official corruption, and growing economic inequalities partly explain why one of the best-selling books in the People's Republic is Song Hongbing's *Currency Wars* – an angry, half-baked account that blames financial crises on "conspiracies by the rich national elites and the Jews seeking world domination," and says that China should be prepared to fight "bloodless wars" waged by evil forces like the US Federal Reserve aimed at destroying China's economy. Even if Beijing dismisses the ranting of a crack-pot, it realises that the fruits of economic development need to be more widely shared – and the best way is to foster domestic demand.

## Conclusion

Beijing is no doubt deeply concerned about the trajectory of the American economy. They have every reason to be worried. If current trends continue, China's huge dollar-denominated foreign reserves could lose significant value in coming years. The literally unrestrained printing of money by the United States has the real potential for generating run-away inflation – which in turn will decimate the underlying value of China's hard-earned dollar holdings. Compounding this is

51. Yongding Yu, "Asia: China's Policy Response to the Global Financial Crisis," *Journal of Globalization and Development*, vol. 1, no. 1, 2010, pp. 1-10.

52. Martin Feldstein, "Resolving the Global Imbalance: Dollar and U.S. Savings Rate," *The Journal of Economic Perspectives*, vol. 22, no. 3, Summer 2008, pp. 113-126.

the genuine fear of the United States imposing ever more onerous conditions. Not surprisingly, these gnawing concerns have made Beijing increasingly irritated by the “self-serving” statements coming from Washington. This very much explains the growing assertiveness on the part of China, especially its willingness to roundly criticise US economic policies – especially those pertaining to China. In a sense, the tables are now turned. For years, Washington has pushed China (and other emerging economies) to emulate US-style free-market capitalism. Among other things, this has meant that China should liberalise capital flows and let its currency appreciate in line with market forces. Not long ago such American “advice” had the sympathetic ears of reformers in Beijing. As the so-called “Anglo-American model” of capitalism has fallen increasingly out of favour, critics have become increasingly emboldened.<sup>(53)</sup> China will not be alone in criticising – sometimes sharply – its erstwhile debtor.

## Postscript

The crisis in the euro-zone is particularly bad news for China. The euro has plummeted against the *renminbi* (whose value is pegged to that of the dollar) making Chinese exports to Europe less competitive, while giving euro-zone companies an advantage in the Chinese market. The euro’s fall makes it less likely that Beijing will break the *renminbi*’s peg to the dollar (to appease Washington, Chinese policy makers had earlier alluded to the possibility of breaking the dollar peg and letting the *renminbi* modestly rise in value). Now, the *renminbi*’s rise against the dollar would also mean a further increase in its value against the euro, thereby making Chinese exports to Europe much less competitive. Not surprisingly, on 24 May 2010, during the start of the second round of the “US-China Strategic and Economic Dialogue,” Beijing once again repeated its commitment to reform its currency – but based on “independent decision-making” and at its own pace, meaning Beijing will not let the *renminbi* rise. This problem will be further exacerbated if there is tighter access to trade finance from Chinese and foreign banks. Chinese exporters rely very heavily on bank letters of credit to finance their shipments – and a sovereign debt crisis usually leads to a cut in the issuance of letters of credit for trade finance.<sup>(54)</sup>

On 10 June 2010, during a heated Senate Finance panel hearing on US-China trade relations, both Democratic and Republican lawmakers heaped criticism on Geithner and

the Obama administration for their lack of progress in dealing with Beijing’s mercantilist economic and currency policies. Senator Schumer angrily noted, “Billions and billions of dollars, millions and millions of jobs flow to China simply because their currency is manipulated.” He warned that Congress is now working on legislation that would impose tough trade sanctions on China. Schumer noted: “China’s mercantilist policies continue to undermine the health of U.S. industries, so this is fair warning... despite the administration asking us not to do it, we are going to move forward with our bipartisan legislation.... I am confident that this bill will pass the Senate with overwhelming support. The issue here is not U.S. protectionism but China’s flouting of the rules of free trade.” It remains to be seen how long the administration can resist the growing congressional pressure.<sup>(55)</sup> On 19 June 2010 (a week before the Group of 20 summit), China’s central bank released a statement signalling the possible end to the *yuan*’s 23-month-old dollar peg.<sup>(56)</sup> Beijing made clear that domestic economic conditions were behind the shift, stating that “the recovery and upturn of the Chinese economy has become more solid with the enhanced economic stability... It is desirable to proceed further with reform of the *renminbi* exchange-rate regime and increase the *renminbi* exchange-rate flexibility.”<sup>(57)</sup> However, the

53. Joseph E. Stiglitz, “China: Towards a New Model of Development,” *China Economic Journal*, vol. 1, no. 1, February 2008, pp. 33-52.
54. Shalendra D. Sharma, “Dealing with the Contagion: China and India in the aftermath of the Subprime Meltdown,” *China and the World Economy*, vol. 17, no. 2, March-April 2009, pp. 1-14.
55. Ian Talley and Tom Barkley, “US Lawmakers Press Geithner on China Currency, Trade Policies,” *The Wall Street Journal*, 10 June 2010, [http://online.wsj.com/article/BT-CO-20100610-711862.html?mod=WSJ\\_latestheadlines](http://online.wsj.com/article/BT-CO-20100610-711862.html?mod=WSJ_latestheadlines); Martin Crutsinger, “Geithner pressed by Congress on China currency,” Associated Press, 10 June 2010, <http://finance.yahoo.com/news/Geithner-pressed-by-Congress-apf-2170249732>.
56. The People’s Bank of China, “Further Reform the RMB Exchange Rate Regime and Enhance the RMB Exchange Rate Flexibility,” 19 June 2010, <http://www.pbc.gov.cn/english/detail>; also see William R. Cline, “Renminbi Undervaluation, China’s Surplus and the US Trade Deficit,” *Policy Brief*, no. PB10-20, Washington, DC, Institute for International Economics, August 2010.
57. Back and Browne observe, “The argument over whether China should allow its currency to appreciate was fierce and public: The Ministry of Commerce, a strong backer of Chinese exporters, was adamantly opposed to a stronger *yuan*. The People’s Bank of China which is responsible for the overall health of the economy took a different view: A stronger *yuan* helps China combat inflation by bringing down the cost of imports, including energy and raw materials.... Beijing has always insisted that it will only carry out currency reform when its economic conditions permit. A raft of economic data out last week, including surging exports and rising inflation in May, likely convinced Chinese policy makers that the time had come. China’s consumer price index rose 3.1% in May from a year earlier, above the psychologically significant 3% level, which is Beijing’s official target for average inflation over all of 2010. A stronger *yuan* can help tame inflation by reducing the price of imports. In theory, a more flexible exchange rate should also strengthen the independence of China’s monetary policy, allowing it to raise interest rates without fearing an influx of foreign money seeking high returns on *yuan*-denominated assets.” Aaron Back and Andrew Browne, “Pragmatism Drove Beijing’s Decision to Drop Peg,” *The Wall Street Journal*, 20 June 2010, [http://online.wsj.com/article/SB100014240527\\_48704638504575318671733450594.html?mod=WSJ\\_hpp\\_LEFTTopStories](http://online.wsj.com/article/SB100014240527_48704638504575318671733450594.html?mod=WSJ_hpp_LEFTTopStories).

statement remained vague regarding when the central bank would implement the change. Beijing clearly ruled out a one-time revaluation by noting that there is no basis for “large-scale appreciation.” Beijing’s move will no doubt help deflect criticism from the Obama administration and other G-20 nations at the G-20 meeting in Toronto on June 26-27. Of course, what Geithner has called “vigorous implementation” will silence the critics. While Geithner called the move an “important step,” he also added, “The test will be how far and how fast they let the currency appreciate.”<sup>(58)</sup> However, Senator Schumer cynically noted,

“This vague and limited statement of intentions is China’s typical response to pressure... Until there is more specific information about how quickly it will let its currency appreciate and by how much, we can have no good feeling that the Chinese will start playing by the rules.”<sup>(59)</sup> Schumer warned, “We hope the Chinese will get more specific in the next few days. If not, then for the sake of American jobs and wealth, which are hurt every day by China’s practices, we will have no choice but to move forward with our legislation.”<sup>(60)</sup> •

58. MarketWatch and Ronald D. Orol, “China to ease yuan-dollar peg,” *MarketWatch*, 20 June 2010, <http://www.marketwatch.com/story/story/print?guid=5D521B66-AD70-4E0E-BA4B-275DE549D3FA>.

59. Cara Anna, “China to allow more exchange rate flexibility,” 19 June 2010, [http://news.yahoo.com/s/ap/20100619/ap\\_on\\_bi\\_ge/as\\_china\\_currency/print](http://news.yahoo.com/s/ap/20100619/ap_on_bi_ge/as_china_currency/print).

60. Rebecca Christie and Ian Katz, “Geithner Calls for Follow-Up to China’s Yuan Decision,” *Bloomberg News*, 19 June 2010, <http://www.businessweek.com/news/2010-06-19/geithner-calls-for-follow-up-to-china-s-yuan-decision-update2-.html>.