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China and the United States:

Partners for Managing the Global Economic Crisis?

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"Markets Fall as Fears of Slump Span the World" ran Thursday's front page headline in the normally quite restrained *Wall Street Journal*. Clearly, what had been mainly a financial crisis with a seizing up of interbank and commercial bill markets, is now spreading with full force to the "real" economy. Consumption and investment spending in the industrial center of the world economy is falling, with even sharper downturns—coupled with currency crashes— in economies producing primary products on the periphery. Although less severely impacted by the global downturn than the American or European economies, China's high-growth economy is slowing more than most analysts expected.

Beyond making every effort to unblock credit markets, what is the best way to mount a global countercyclical policy?

Though China and the United States are an unlikely duo to mitigate the current economic crisis, they have good reasons to cooperate. Both have strong vested interests in ameliorating a global downturn while preserving the foreign exchange value of the dollar. Trade between them is huge, but extraordinarily unbalanced. China is the largest creditor of the United States, nervously holding nearly two trillion dollars in foreign exchange. The large U.S. trade deficit in manufactures with China (and East Asia more generally) has contracted the U.S. manufacturing base and inflamed American politics by throwing red meat to the protectionists. A cooperative economic program that addresses the near-term global macro crisis on the one hand, and the festering China-U.S. trade imbalance on the other, is feasible and highly desirable.

The collapse of the U.S. housing bubble in 2007-08 is the proximate reason for the worldwide spread of the credit crisis. Aggregate demand in the global economy is declining

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because of the retrenchment in U.S. household spending, which is necessary to reduce the U.S. trade deficit. Because the Federal Reserve overreacted by cutting interest rates too much, up to three months ago, the flight of hot money from the dollar worsened the seizing up of credit markets in the United States. When counterparty risks are acute, the huge U.S. interbank markets are further impaired because of a shortage of prime collateral in the form of U.S. Treasury bonds. As foreign central banks, such as the People's Bank of China (PBC), intervene to buy dollars to prevent their currencies from ratcheting upward, they invest the proceeds disproportionately in U.S. Treasuries and so incidentally worsen their shortage in private U.S. financial markets.

But China also has domestic financial problems including a banking squeeze. Because of ultra low U.S. interest rates and American "China bashing" to appreciate the renminbi, the deluge of hot money inflows into China had forced the PBC to buy dollars in the foreign exchange market to prevent the renminbi from ratcheting up sharply. True, the surprise strengthening of the dollar over the past three months has provided a respite from continual renminbi appreciation. But just the expectation that the renminbi is likely to be higher in the future impedes private capital outflows from financing China's huge trade surplus—and so further tightens credit conditions in the United States and Europe.

From the inordinate build up of China's official foreign exchange reserves, Chinese money growth had been excessive and led to too much inflation—some of which leaked out into the rest of the world. In trying to sterilize the domestic monetary consequences of the rapid buildup of official exchange reserves, the PBC has had to impose high reserve requirements on its commercial banks. But having to hold renminbi reserves on deposit with the PBC impedes the commercial banks' lending to the private sector.

To deal with the global crisis, how should the U.S. and Chinese governments proceed?

First, the U.S. should stop China bashing in several dimensions. In particular, the PBC should be encouraged to stabilize the yuan/dollar exchange rate at "today's" level—both to lessen the inflationary overheating of China's economy and to protect the renminbi value of its huge dollar exchange reserves. Since July 2008, the dollar has strengthened against all currencies save the renminbi and the yen, and the PBC has stopped appreciating the RMB against the dollar. So now is a good time to convince the Americans of the mutual advantages of returning to a credibly fixed yuan/dollar rate.

There is a precedent for this. In April 1995, the U.S. Treasury Secretary Robert Rubin ended 25 years of bashing Japan to appreciate the yen—and announced a new strong dollar policy that stopped the ongoing appreciation in the yen and saved the Japanese economy from further ruin. But this policy was incomplete because the yen continued to fluctuate, thus leaving too much foreign exchange risk within Japanese banks, insurance companies, and so forth, with large holding of dollars. This risk locks the economy into a near zero interest liquidity trap.

Second, after the PBC regains monetary control as China's exchange rate and price level stabilize, the Chinese government should then agree to take strong measures to get rid of the economy's net saving surplus that is reflected in its large current account and trade surpluses. This would require some combination of tax cuts, increases in government expenditures, increased dividends from enterprises so as to increase household disposable income, and reduced reserve requirements on commercial banks. Then, as China's trade surplus in manufactures diminishes, pressure on the American manufacturing sector would be relaxed with a corresponding reduction in America's trade deficit. Worldwide, the increase in spending in China would offset the forced reduction in U.S. spending from the housing crash.

Again there is an important historical precedent. In the great crisis of 1997-98, most East Asian countries depreciated their currencies--with Indonesia, Korea, Malaysia, Philippines, and Thailand, whose currencies were attacked, suffering steep economic slumps. Fortunately, China alone kept its dollar exchange rate stable, but it did face a potential deflationary slowdown. However, in March 1998 Premier Zhu Rongji announced his famous trillion dollar fiscal expansion to be spread out over the next four years or so. This avoided an economic downturn in China by sustaining domestic aggregate demand, and East Asian neighbors recovered faster because they could more easily export to China.

Now China is a much bigger actor on the world stage. So with the slump in spending in the U.S. and elsewhere, China should step in with a big new fiscal expansion, which it is well placed to do because of its huge trade surplus that should be reduced anyway. China’s public finances are now very strong with a surge in tax revenues, and the old bad loan problem with its banks has been largely corrected as enterprises—both state-owned and private—are now very profitable.

In contrast, the U.S. public finances are in a mess. The pre-crisis fiscal deficit is still with us. In addition, the government has taken on huge new contingent liabilities from bailouts of innumerable financial institutions that will hamstring the federal budget for years to come. Thus any new U.S. fiscal “stimuli”, or big new spending programs not covered by tax increases, should be out of the question. Even if implemented, they would wind up increasing the trade deficit.

In summary, a “negotiated” fiscal expansion in China (and possibly in other trade-surplus countries such as Germany and Japan) with a formal end to China bashing so as to secure the yuan/dollar rate as the quid pro quo, would seem to be the most promising way of mitigating a global slowdown.