How Can China Help the U.S. Economic Recovery?

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1. Despite its rapid growth, the Chinese economy, with a GDP of US$4.91 trillion, is only a third of the size of the U.S. economy, with a GDP of US$14.26 trillion. On a per capita basis, the Chinese GDP is considerably lower, less than US$3,700 compared to the U.S.'s US$46,100. It is at least twenty years too early to talk about the Group of Two (G-2).

2. However, China can help marginally by staying invested in U.S. Treasury and Agency securities as well as in U.S. Dollar denominated assets. This China has done and can be expected to continue to do so in the future. The People's Bank of China (China's Central Bank) is currently the World's largest single investor in U.S. Treasury and Agency securities, with holdings of approximately US$800 billion. More recently China has lent its support for the Euro by announcing publicly that the People's Bank of China will not be reducing its holdings of Euro-denominated assets, thus helping to calm and stabilise financial markets around the World.

3. A country's currency is considered under-valued if it runs persistent surpluses in trade in goods and services combined vis-à-vis the entire World. It is considered over-valued if it runs persistent trade deficits vis-à-vis the World. China has had essentially balanced trade in goods and services combined with the World until 2005 and that its trade surplus with the World has once again become insignificant beginning in early 2010. If current trends continue, China will once again return to the position of essentially balanced trade with the World at the end of 2011. In contrast, the large U.S. trade deficit with the World existed since at least 1998, long before China began to have a trade surplus with the World, in 2005. What this means is that while there is evidence that the U.S. Dollar might have been over-valued, there is no evidence that the Renminbi was under-valued prior to 2005.

4. Because of the trade surpluses vis-à-vis the World since 2005, the Renminbi was allowed to appreciate in July 2005, and actually rose 20 percent in nominal terms and 25 percent in real terms by the end of 2008. Partly as a result, the bilateral U.S. trade deficit with China has narrowed significantly since 2007, even though it remains large. There is U.S. pressure on China for a further revaluation of the Renminbi. However, while a revaluation of the Renminbi may help reduce the bilateral U.S. trade deficit with China, it may not help reduce the U.S. trade deficit vis-à-vis the World. This is because the U.S. has not been producing most of the goods that it has been importing from China, such as garments, shoes and toys, for decades. What the U.S. does not import from China, it will import from elsewhere rather than manufacture in the U.S. What is important to the U.S. economy is not a revaluation of the Renminbi per se. What is important is an increase of U.S. net exports. A revaluation of the Renminbi is unlikely to achieve the objective. More direct actions and measures are needed to increase U.S. net exports.

5. China can increase its imports from the U.S. in two principal areas. The first area is in the high-technology sector. Chinese demands for high-technology capital goods continue to be high and are rising rapidly—such as transportation equipment (aircraft including helicopters), semi-conductor manufacturing equipment, super-computers and nuclear reactors. However, the U.S. Government has not allowed the exports of many such products on the grounds that they can potentially be used for military as well as civilian purposes. The purpose of an export control policy is to prevent militarily valuable technology from falling into the hands of a potential adversary. Such a policy is understandable if the product in question is only available from U.S. firms. However, it is of somewhat dubious effectiveness if the same comparable product is also available from other countries

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or even from Chinese firms. U.S. exports to China can be significantly increased if the U.S. adopts a policy that exports will be allowed if a product of comparable technological sophistication is demonstrably available from non-U.S. suppliers. This is because if the technology is already available elsewhere, export control can only work against the interests of U.S. firms, without any real benefits for U.S. national security.

6. The second area is in the agricultural sector. Agricultural commodities such as grains (maize, rice and wheat), soybeans and meat (beef, chicken and pork) all have potentially large demands in China. The U.S. has the capacity to increase production and exports to China in all of these commodities. In order for trade in agricultural commodities between U.S. and China to be successful and sustainable, the U.S. farmers must, on the one hand, be assured that the Chinese demand is long term, so that they are willing to put land back into cultivation, invest in the necessary equipment, and employ and train the necessary manpower, and the Chinese importers must, on the other hand, be assured of the reliability of the U.S. supply. A one-off purchase of agricultural commodities by China will not induce the expansion in U.S. output, investment and employment. Food security is crucial to China, so that Chinese importers must be assured that they can count on receiving the U.S. exports year in and year out. Thus, what is needed is a long-term (ten or twenty years, for example) supply contract between the two sides, with prices indexed to costs in the U.S. One way for China to be credibly assured that the supply is not likely to be interrupted for any reason is for the U.S. side to put into storage in warehouses in China a supply equal to one year of contracted exports (as a bond), with the contents withdrawable by the Chinese importers in the event of an interruption of exports from the U.S.. However, with such storage in place, it is unlikely that U.S. exports to China will be interrupted since it will serve no useful purpose, except to nullify the remainder of the supply contract, causing losses to the U.S. farmers. If such a long-term supply contract can be negotiated by the two sides, it is not only win-win economically, but will help stabilise and cement the long-term friendly relationship between the two countries.

7. Both U.S. and China should actively promote tourist groups from China to visit the United States. Many surveys have shown that the U.S. is a most admired country in China. Many Chinese citizens would like to visit the U.S. And there are many potential destinations: San Francisco, Los Angeles, Las Vegas, Chicago, New York, Washington, Philadelphia, Boston, Atlantic City, New Orleans, Houston, Yosemite, Yellowstone, Grand Canyon, Niagara Falls, Williamsburg, Charleston, and Hannibal, Missouri, to name only a few. Mainland Chinese tourists to Hong Kong currently exceed 20 million a year, spending an average of US$500 per day in Hong Kong. The demands created by tourism on hotels, restaurants, retail stores and transportation are the principal reason for the relatively low unemployment rate in Hong Kong. Now Hong Kong is a relatively small place. A large country like the U.S. can attract many more tourists from China who will also be able to stay much longer. Assuming that it is possible to have in steady state 20 million Chinese tourists visit the U.S. a year (initially mostly in groups), with each spending twelve days (2 weeks) in the U.S., we are looking at a potential US$120 billion of expenditure a year, 100 percent spent in the U.S. This is a significant amount, and will narrow greatly the U.S.-China trade deficit, and the economic benefits in terms of income and employment will be widespread geographically as well as across different income strata. But the benefits will go way beyond economics: tourism on such a scale will greatly enhance friendship and understanding between the peoples of the United States and China. Of course, one cannot achieve 20 million tourists a year from China overnight, but one can start with a million a year first, allowing say the residents from Shanghai to have easier visa access to the U.S. It will generate revenues of US$6 billion a year.

8. The People's Bank of China (China's Central Bank) now has the World's largest official foreign exchange reserves, an amount approaching US$2.5 trillion. Chinese national savings rates continue to be very high, hovering between 40 and 50 percent. Chinese firms, institutions, and households have the capacity to make significant portfolio as well as direct investments overseas, and the Chinese Government has removed many barriers to such investments. Further liberalisation of capital control, especially outbound capital flow, will be forthcoming. Such investments can be very helpful to U.S. firms, especially financial institutions, as the U.S. economy is in the process of deleveraging, that is,

increasing the ratio of its equity capital to assets. During this process, China can be a valuable source of long-term capital.

9. All U.S. firms, especially financial institutions, are or will be going through the painful process of de-leveraging. The financial institutions can meet the capital adequacy requirements by either decreasing their assets, which means they must contract the credit they have extended to their customer firms, impeding the economic recovery, or increasing their equity capital. But this is not a good time to try to raise equity capital in the U.S. Foreign portfolio investment or foreign direct investment (FDI) from China in U.S. financial institutions and firms can facilitate the de-leveraging process so as to avoid a massive credit contraction in the U.S. FDI from China can be facilitated if safe harbour rules can be drawn up by the U.S. Government of the nature and type of direct investment (industry, percentage ownership) that will be readily approved for Chinese investors. This can be done reciprocally, so that the Chinese side can also come up with a list of safe harbour rules for U.S. direct investors investing in China. With these lists, a great deal of uncertainty will be eliminated in cross-country direct investment by investors from both countries.

10. The recapitalisation of U.S. financial institutions and firms can also be facilitated by allowing them to do private placement of their new shares or capital securities (e.g., convertible bonds) in China or to list new shares publicly on the Shanghai Stock Exchange as China Depositary Receipts (CDRs) traded in Renminbi. Any such equity capital raised can be remitted back to the U.S. in the form of U.S. Dollars. China can also assist in the exit strategy of the U.S. and other governments from their current support of their financial institutions to help maintain global financial stability.

11. China would also like to be able to purchase and to hold long-term Treasury Inflation-Protected Securities (TIPS) issued by the U.S. Treasury. This can also be win-win for both the U.S. and China. With TIPS of long maturity, China does not have to be concerned with either short-term inflation in the U.S. or short-term fluctuations in the prices of U.S. Treasury securities. Because the Chinese holdings are long-term, the U.S. does not have to roll over as large a volume of Treasury securities each year, enhancing the stability of the U.S. capital market. In addition, the issuance of TIPS of long maturity by the U.S. Treasury also enhances the market confidence that U.S. inflation will remain under control.

12. The United States has the lowest gasoline price in the World. China used to have that dubious distinction, but has since raised its domestic price of gasoline above that of the U.S. The United States and China are also the World's two largest importers of oil and gas. Together they have enough market power to influence the World export prices of oil and gas. A global oil and gas import tax will encourage conservation, lower the demands for oil and gas, raise government revenue for all net-oil-and-gas importing countries and help prevent global warming. The incidence of such a tax will be borne by the oil and gas exporting countries and the oil and gas consumers, with the latter possibly compensated in part by the additional government revenue generated from such a tax. U.S. and China can jointly promote such a global import tax on oil and gas. The two countries can also agree to impose an oil and gas import tax themselves even in the absence of an agreement by all oil and gas importing countries on a global oil and gas import tax. The actual implementation of the oil and gas import tax can be scheduled for three years into the future to allow all the consumers the time to make the necessary adjustments (e.g., to buy more fuel-efficient automobiles). Even the announcement of such a tax alone will have substantial impact on the World export prices of oil and gas. Such a tax, if imposed by the U.S. on its imports, will reduce significantly both the prices and the quantities of oil and gas imports by the U.S., which will in turn reduce significantly, if not eliminate, the U.S. trade deficit vis-à-vis the World. A reduction of the U.S. trade deficit is positive and expansionary for the U.S. economy. And the import tax revenues should help reduce the U.S. government deficit, which will be well received in the capital markets and will lower U.S. inflationary expectations. Finally, in the aftermath of the BP oil spill in the Gulf of Mexico, now is a good time for the U.S. to consider imposing such an import tax. The U.S. can of course impose the import tax entirely on its own, but with China imposing a similar import tax at the same time, their combined

market power will be so much bigger that the net oil and gas exporters will have to lower their net export prices.

13. The Chinese economy is not large enough to turn around the U.S. economy, but on the margin, there are many ways in which China can help the U.S. economic recovery and also benefit itself. These win-win opportunities should be actively promoted and pursued.