

# Core Economic Issues in U.S.-China Relations: Currency, the Trade Deficit, Investment and Finance, Food and Product Safety

*Nicholas Lardy, Ph.D.*

Senior Fellow

Peterson Institute for International Economics

## **Global Economic Imbalances and the Chinese Currency**

In contrast to the first 25 years of reform when its net external trade position was very modest, in the past few years China has become a major contributor to global economic imbalances. This is reflected in China's soaring current account surplus, which reached \$250 billion in 2006 making it the world's biggest current account surplus country. The surplus expanded further in 2007 on the back of a 50 percent increase in the trade surplus and is anticipated to have reached close to \$400 billion (official data on the current account are expected to be released in May). That will place China's global current account surplus in 2007 at almost 12 percent of Gross Domestic Product (GDP), an unprecedented level for one of the world's top trading economies. For comparison, recall that Japan's global current account surplus in the mid-1980s, at the height of trade frictions with the United States, peaked at 4.3 percent of its GDP.

The emergence of trade and current account surpluses on the scale that have occurred in China in the past three years appears to reflect perhaps the most important economic policy error of the reform era, not the adoption of mercantilist trade policies. Indeed, unprecedented trade surpluses emerged after China joined the World Trade Organization (WTO) in late 2001 and was opening its market to

foreign trade and investment by dismantling a large number of trade barriers and liberalizing further its foreign investment regime. What was the nature of this policy error?

China's policy error was its failure to recognize that its fixed exchange rate vis-à-vis the U.S. dollar would, as the value of the dollar fell from its peak in February 2002, inevitably make Chinese goods more competitive globally and thus, with a time lag, lead to a rising global trade surplus. They also appear not to have appreciated sufficiently the rapid pace of productivity growth in China's export sector. This allowed export producing firms to lower their prices in domestic currency while maintaining their profitability, which compounded the tendency for Chinese goods to become ever more competitive globally.

For part of this decade the rise in China's global trade surplus coincided with a rise in the U.S. global trade deficit. But developments in the past two years underscore the fact that the correlation of these trends does not imply unique causation. In response to the depreciation of the U.S. dollar, which has now fallen about 15 percent on a trade weighted basis since its February 2002 peak, and to the improvement in the U.S. national savings-investment imbalance (due largely to a declining fiscal deficit) the pace of expansion of the U.S. trade and current account deficits began to moderate as early as 2005. Since the

third quarter of 2006 these deficits have been shrinking both in absolute terms and as a share of GDP while, as already noted, China's global trade and current account surpluses have continued to rocket ahead.

This delinking between the external positions of China and the United States is likely to continue as households in the United States begin to increase their savings from disposable income in response to declining housing prices. And if economic growth in the United States should slow further in 2008, or the U.S. even tip into recession, this disparity would be further accentuated since demand for imports in the United States would fall sharply, accentuating the pace of decline in the large U.S. global deficit that is already underway.

Nonetheless, China could contribute to a more rapid reduction in the U.S. global external deficit by rebalancing its own economy, reducing its dependence on a growing external surplus and an excessively high level of domestic investment but maintaining rapid economic growth through increased government outlays on social programs and by adopting policies to encourage more robust private consumption expenditures. The Central Committee of China's Communist Party called for rebalancing as early as 2004, focusing at that time primarily on reducing China's excessive dependence on investment to generate high economic growth. Premier Wen Jiabao in the spring of 2007 expanded the rebalancing agenda by calling for a reduction in what he called China's "excessive trade surplus." Achieving this objective will require not only a further appreciation of the Chinese currency (a process that has been underway for three years) but also adjustments in both its fiscal and financial policies.

A faster pace of currency appreciation, which appears to have emerged in December 2007, if sustained would tend to reduce the growth of Chinese exports and contribute simultaneously to faster import growth. Several other Asian countries with undervalued exchange rates would likely follow China's faster appreciation

by allowing their own currencies to appreciate more rapidly. That, in turn, would lead further to the decline in the trade-weighted value of the dollar, contributing to a further reduction in the U.S. global current account deficit.

On the fiscal side the Chinese government needs to significantly increase the dividend tax on state-owned corporations introduced last year. Profits of these firms have soared in recent years and become the major source of investment finance. A sharply higher dividend tax would not only cut business savings and thus reduce corporate investment as well, but it would also provide the government with additional fiscal resources to increase government outlays for health, education, and pensions. That, in turn, would encourage households to save less and spend more, a necessity if China is to transition to more consumption driven growth—the key goal of its rebalancing strategy.

Finally, the central authorities need to abandon their policy of heavy financial repression that has caused household interest income as a share of GDP to fall sharply, even as the stock of household savings in banks has risen considerably. China is not likely to be able to transition to a more consumption driven growth path if household income as a share of GDP continues to fall, largely as a result of declining returns to savings.

To date Chinese policy initiatives along these lines have been modest. Through December 2007 the trade weighted real value of the RMB (Chinese currency) had appreciated only 3 percent from June 2005, just prior to the time the authorities began to allow the exchange rate to move above its long time fixed rate of RMB 2.8 per US dollar. The government, however, has reinforced currency appreciation with several other policy moves that have the same effect as currency appreciation, i.e., increasing the cost of Chinese goods in global markets and reducing the price of imported goods in China. The rate at which the domestic value added tax is rebated to producers on goods that are exported has been reduced for a broad range of goods

and for some goods eliminated entirely; import duties on a few goods have been reduced below the levels mandated by China's WTO commitments; and duties have been newly imposed on some export goods.

Government outlays for health and education programs have increased sharply in absolute terms since 2004. This has allowed, for example, the elimination of primary school fees throughout China and provided a substantially larger share of the population with at least some health insurance coverage. If sustained these increases are likely to reduce the precautionary demand for savings on the part of China's households and thus lead to greater private consumption outlays relative to disposable income.

On the financial front less progress has been made since multiple interest rate increases in the past two years have not kept up with rising inflation, leaving savers earning ever lower real returns.

On balance the prospect is that the rate of expansion of China's trade surplus will slow further in 2008. By 2009 the external surplus is likely to peak in absolute terms at a very elevated level or even begin to shrink slightly. Thus, in the near term, further reduction in the U.S. global external deficit will have to depend largely on domestic economic adjustments in the United States.

### **China's Foreign Exchange Reserves**

As a consequence of the heavy intervention by the Chinese authorities to slow the pace of RMB appreciation in recent years China has accumulated far and away the world's largest stock of official foreign exchange reserves. By the end of 2007 reserves stood at \$1.53 trillion. While China, like most countries, does not disclose the currency composition of its reserves, it is widely believed that about two-thirds, or about \$1 trillion at year-end 2007, were held in the form of U.S. dollar claims. The balance was held in assets denominated in other currencies, such as the Euro and the Japanese

Yen. China's holdings of U.S. Treasuries are estimated at \$425 billion. Its holdings of so-called U.S. agency issues, mostly mortgage backed securities that are guaranteed by Fannie Mae and other U.S. federal agencies, amount to approximately \$400 billion. The balance of China's dollar-denominated reserves is held mostly in corporate debt.

There are several apprehensions concerning China's large and growing holdings of dollar denominated financial assets, especially U.S. government bonds. Perhaps the most important is the fear that China's investment position somehow gives it leverage over the United States, because it can threaten to reduce its dollar holdings in response to U.S. policies it finds objectionable. In theory this could lead to an increase in interest rates in the United States, thus slowing U.S. economic activity.

It is probably more accurate to say that China's large holdings of dollar assets makes the two countries mutually interdependent in financial terms rather than providing unilateral leverage to China. As long as domestic savings in the United States are insufficient to finance our investment we will have to borrow the difference from the rest of the world. As long as China continues to have domestic savings that are well in excess of its domestic investment it will have to lend these surplus funds internationally. If China sought to put a substantially smaller portion of its growing foreign exchange reserves into U.S. dollar denominated assets or to sell a substantial portion of its existing dollar holdings and replace them with assets denominated in other currencies, interest rates in the United States likely would adjust upward slightly, at least in the short run. Depending on the posture of U.S. monetary policy at the time, this could impose a real economic cost on the United States. On the other hand, because this adjustment by the Chinese would drive the value of the dollar down, it would cause China to sustain large capital losses on its remaining holdings of dollar denominated assets. With Chinese reserves at year-end 2007 equal to the equivalent of half its GDP, losses associated

with a decline in the value of the dollar could be substantial. Thus mutual interdependence between the United States and China reduces the risk that China would attempt to use its large foreign exchange reserves as a lever to unilaterally advance its own interests at the expense of the United States.

Finally, as countries with large foreign exchange reserves seek to increase their returns many have transferred more and more of these funds to sovereign wealth funds that seek higher returns than are available from the predominantly fixed income investments made by central banks. China joined this process last year when it created the Chinese Investment Corporation (CIC) to invest a portion of China's reserves. In recent months, as these funds (including CIC) have invested almost \$40 billion in large U.S. banks, investment companies, and other financial institutions, two broad questions have been raised.

First, the motives of sovereign wealth funds are not necessarily simply balancing economic returns and risks. They may seek to promote the economic interests of their own country or pursue geopolitical goals that would not otherwise be an element in the business decisions of the financial institutions these funds, in effect, are rescuing. The absence of much transparency of most sovereign wealth funds makes it difficult to judge their motives or even to identify their principal investments.

The second issue is whether the existing U.S. regulatory framework should be adjusted to subject the investments to closer scrutiny and perhaps restrictions. The U.S. Treasury appears to have responded to these concerns not by proposing adjustments to the CFIUS (Committee on Foreign Investment in the United States) process, but by asking the International Monetary Fund to encourage sovereign wealth funds to increase their transparency and to agree voluntarily to a code of conduct that would reassure the United States and other countries in which these funds are investing. The terms of this code and its enforcement provisions will be key U.S. policy interests.

## **Food and Product Safety**

In 2007 concern in the United States about the safety of food and other products imported from China soared as the media reported on a growing list of problem imports from China, including pet food, fish, toothpaste, and toys. This led President Bush in July to establish The Interagency Working Group for Import Safety. It was charged with analyzing the strengths and weaknesses of existing mechanisms to ensure import safety and to develop a plan to remediate any deficiencies in the system. By November the Group released its Action Plan for Import Safety.

The main thrust of the Action Plan is to seek to enlist the Chinese bureaucracy to enforce standards set by the United States Food and Drug Administration (FDA) and other federal agencies. This approach was formalized in two bilateral agreements signed in December 2007. One, between the United States Department of Health and Human Services (HHS) and China's General Administration of Quality Supervision, Inspection, and Quarantine (AQSIQ), covers the safety of food and feed. A second, between HHS and the State Food and Drug Administration of China (SFDA), covers drugs and medical devices.

Under the first agreement producers of food for export from China will have to register with AQSIQ and allow annual inspections. AQSIQ will issue certificates to firms that meet FDA standards.

In practice this may or may not lead to the desired result. AQSIQ has long had a process of registration and certification that seeks to restrict food exports to products originating in registered plants that are certified to meet certain standards. In 2007, before the signing of the bilateral agreement with HHS, AQSIQ had registered 12,700 food producers. While this might seem impressive, it accounted for less than 3 percent of food producing firms in China. Most of the food products with safety problems imported into the United States have been imported by companies not registered and certified by AQSIQ. Since the U.S. FDA

currently inspects less than 1 percent of food imported into the United States and does not even have inspectors at some U.S. ports, it is not clear that raising the certification standards used by AQSIQ will significantly reduce problems with the safety of food imported into the United States.

More importantly, while it undoubtedly is useful to engage the Chinese in enforcing the appropriate safety standards for their exports, it is important to recognize that the capacity of AQSIQ and particularly SFDA is quite limited. This is starkly clear in the bilateral agreement covering drugs and medical devices, which states that SFDA “will work toward a system that will enable it to certify that firms that manufacture products” for export to the U.S. “meet U.S. FDA requirements.” While the agreement envisions joint training programs that will help to build Chinese capacity, this is a long-term process and there are no deadlines for developing the certification program called for in the bilateral agreement covering drugs and medical devices. Indeed, under the current Chinese regulatory framework, SFDA does not even have the authority to regulate exports of drugs and medical devices from China. It apparently has agreed to seek this authority from the Chinese government.

At the end of the day the safety of food and other products imported into the United States is a joint responsibility of producers abroad and their governmental regulators, firms that import and sell these products in the United States, and the U.S. government. The Chinese government has responded forcefully, announcing a host of initiatives to improve food and product safety. Its capacity to fully implement these initiatives remains to be demonstrated.

Importers and sellers of Chinese products too have announced steps to improve product safety. Mattel, for example, after being forced

to announce repeated recalls of faulty Chinese toys, apologized to China and to its U.S. customers, acknowledging that defects in some items arose because of design flaws rather than faulty manufacturing. And it admitted that by not checking its own Chinese subcontractors it had not fully enforced its own safety guidelines, which ban the use of lead paint. It vowed to remedy its failures.

The U.S. government, on the other hand, has focused primarily on encouraging the Chinese government to enforce stronger safety standards rather than taking stronger initiatives at home. The Import Safety Action Plan announced by the President’s Interagency Working Group on Import Safety conspicuously failed to recommend either increased inspections of imports entering the United States or increased funding for U.S. agencies responsible for safety of goods reaching U.S. consumers. Indeed the action plan argues that “our nation can not inspect its way to safety.” Since 2001 food imports into the United States have doubled, but funding for the FDA has been frozen. The attitude that increased inspections and enforcement in the United States are not important persists. An FDA commissioner in testimony before Congress in late January 2007 said the agency was not sure whether it would ask for additional funding for more inspectors or whether it would place staff in China who would be charged with building the capacity of Chinese agencies to carry out agreed upon registration and certification standards. Similarly the administration is not seeking increased funding for the Consumer Product Safety Commission. Its budget, even before correcting for inflation, is now less than half the level of 1974, the year it was created.

Thus the key question remains. Do we have the right mix of policies to improve safety of food and other products imported from China?