ROOM FOR DEBATE A Running Commentary on the News

November 17, 2009, *11:54 am*

China's War on Low U.S. Interest Rates

By THE EDITORS

Jim Young/Reuters President Obama and Secretary of State Hillary Clinton met with President Hu Jintao and other Chinese leaders at the Great Hall of the People in Beijing on Tuesday.

Updated, Nov. 17, 6:35 p.m. | Moritz Schularick, an economic historian, says China is partly to blame for Americans' addiction to cheap money.

After their summit meeting on Tuesday, President Obama and President Hu Jintao of China announced that they had agreed on many issues. But their statement was vague, in contrast to the pointed criticisms Chinese officials have been making of American financial policies in recent days. Over the weekend, China's top bank regulator attacked the low interest rates in the United States, even though the Federal Reserve continues to indicate that it will not raise them anytime soon. Would higher rates in America be in China's best interests anyway? While Chinese investments might earn higher returns, if American consumers spend even less if it costs more to borrow, would that be a bigger problem? Or is China less and less dependent on Americans' ability to buy its products?

- Moritz Schularick, economic historian, Free University, Berlin
- Michael Pettis, Peking University
- Yves Smith, financial analyst
- John Ross, Shanghai Jiao Tong University

Beijing Is Partly to Blame

Moritz Schularick is a professor of economic history at the Free University in Berlin.

With little regard for diplomatic restraint, Chinese officials have called U.S. monetary and fiscal policies a threat to global economic stability. China's criticism matters, not least because China today is the U.S. government's largest creditor — to the tune of no less than 1,600 billion dollars. It comes as no surprise that Beijing gets nervous when its No. 1 debtor decides to run both zero interest rates and record budget deficits.

China created the macroeconomic backdrop for America's addiction to cheap money.

Yet China's criticism is at least partly off the mark. To be clear, U.S. economic policy-makers and above all the Federal Reserve are not free of mistakes. The Fed misdiagnosed the housing bubble, ignored the growth of leverage in the financial system, and arguably even encouraged excessive risk-taking by pumping liquidity habitually into financial markets when they sputtered. It is also clear that American fiscal policy is on an unsustainable path. The domestic and international consequences of zero interest rates and quantitative easing are hard to judge too.

However, China itself is to some extent responsible for America's addiction to cheap money. By intervening in the currency markets and accumulating historically unprecedented stockpiles of foreign currency reserves, China created the macroeconomic backdrop for the crisis: low long-term interest rates, plentiful liquidity and an ever growing dependence of the American economy on debt-fueled consumption.

By revaluing the renminbi, China could give America the opportunity to check into rehab. The U.S. could earn its way out of the slump and over time lessen its dangerous reliance on policy that stimulates domestic demand. If China decides to let the market determine the value of the renminbi, the highly experimental policies that Beijing complains about today could and would be ended sooner.

When Imbalances Get Out of Hand

Michael Pettis *is a senior associate of Carnegie Endowment and a professor of finance at the Guanghua School of Management at Peking University.*

The criticism by China's top bank regulator, Liu Mingkang, of too-low U.S. interest rates indicates how terribly confused the debate has become. Low U.S. interest rates and the expected depreciation of the American dollar encourage investors to borrow dollars and invest in Asia, where
it may be encouraging additional investment in China, a country that is already drowning in too much investment.

But low interest rates in the U.S. will help reverse the sharp fall in U.S. consumption that has been catastrophic for China's export sector.

China's overinvestment problem was created as part of the imbalance that had Chinese overproduction feeding American overconsumption for many years. China's huge stimulus is likely to increase production even further at the expense of domestic consumption, putting even more
pressure on China to sell its excess capacity to American consumers.

So which hurts China, lower or higher U.S. interest rates? Unfortunately, both. That is the problem with imbalances getting out of hand. They are never easy to fix.

It's Not Because of Low Interest Rates

Yves Smith *writes the blog Naked Capitalism. She has spent more than 25 years in the financial services industry and currently is head of Aurora Advisors, a management consulting firm.* Her book, "Econned: How Unenlightened Self Interest Undermined Democracy and Corrupted Capitalism," will be out in the spring.

The concern about interest rates puts the focus on the wrong issue.

By any standards, the U.S. economy is weak and the odds are high it will get worse before it gets better. Unemployment is still rising, consumer sentiment is worsening, both of which bode ill for a turnaround. The recent return to positive gross domestic product was the result of changes in inventory and the Obama stimulus, both of which are short-term effects.

China's large treasury holdings are the result of keeping its currency artificially cheap.

Normally, that would seem to call for low interest rates to stimulate the economy. But that isn't working. Money is sloshing around the financial system, going more into asset price speculation than productive uses. The mood in the markets has the same feel as the first half of 2008, when inflation fears turned out to be a big head fake.

But where does this leave the dollar and China? Despite the tough talk, China has no one to blame but itself. Its large treasury holdings are the result of keeping its currency artificially cheap. They were never meant to be an investment until they became too large to ignore. They were a huge trade subsidy that the U.S. failed to challenge since getting artificially cheap goods looked like a real deal.

The weak dollar in theory should be closing our trade deficit, but it isn't. The U.S. has ceded so much manufacturing that it will take some time to take advantage of a cheaper greenback. But much more of a fall in the dollar has the potential to lead to a rout or protectionism from our trade partners. And oddly enough, the betting is so heavily on a weak dollar that it is subject to drastic near-term reversal.

The Federal Reserve, and Fed chairman, Ben Bernanke in particular, is certain not to raise rates until it is convinced the economy is recovering. Given how little near-zero interest rates did to revive Japan, the Fed and the "inflationistas" could be in for a very long wait.

China Fends for Itself

John Ross *is visiting professor at Antai College, Shanghai Jiao Tong University.*

President Obama visits China at a true turning point in world financial history — one his advisers have probably not pointed out to him. This year, under the impact of the financial crisis, for the first time for a century and a half the United States has been overtaken as the greatest generator of capital in the world and by the country he is now visiting.

> The world's No. 1 capitalist country — the U.S. — is no longer the world's greatest generator of capital.

To set out the data, the Bureau of Economic Analysis measured combined U.S. company, government and domestic savings, that is the finance generated for investment, in the second quarter of 2009, the latest available data, at $1.4 trillion.

China does not publish quarterly savings data, but it is relatively easy to calculate them from published figures on investment and the balance of payments. At official exchange rates, which understate the size of China's economy, China's finance available for investment, that is its savings, reached slightly over $2 trillion in the second quarter of 2009. This more than $600 billion lead over the United States is sufficiently large that, even allowing for a margin of error given the indirect way China's figures must be calculated, there is no doubt that China has now overtaken the U.S.

The striking reality is that the world's No. 1 capitalist country is no longer the world's greatest generator of capital.

This financial strength is why China has been able to reorient its economy to domestic demand and why its stimulus package has been successful. China would undoubtedly genuinely prefer the U.S. consumer to recover quickly — that would be, in the language it uses, a "win-win situation."

But China is sufficiently financially strong that its economy can expand even if the consumer recovery is rather longer delayed. Meanwhile, a weaker dollar would devalue China's treasury bond and other U.S. holdings and internationally reduce the purchasing power of U.S. consumers to buy China's exports.

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1 .
Ben Gee
Canada
November 17th, 2009
8:57 pm
China is sitting very pretty where it is at: growing at 8+%. China do not have a problem even if some economists try to make it sound like China has a huge problem. They want China to fix things that are not broken for China anyway. On the other hand, US has a huge problem. Deficite and unemployment are both getting out of hand. China will not fall for the trick the US pulled on Japan 20 years ago. If the US think an appreciation of the yuan will help. think again. During 2005-2008, the yuan appreciated 21%, what was the result? US deficite went up 20% and Chinese surplus went up 20%. History may repeat itself. Only US and US alone can save itself. The US has to suck it up get off its behind and go to work and earn its way out of the mess it created. Blaming China is like blame the store for keeping its door open for business. The store is not the problem. Buying thing you can not afford is the problem.
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John
St Paul Minnesota
November 17th, 2009
8:57 pm
The Vietnam War provided the capital for The Gulf states to buy out the Western Oil campanies in the late sixties and early seventies. The US government didn't want to create shortaages in the domestic economy by either rationing or allowing prices to rise, but instead usded oil from the gulf for the Seventh Fleet. The US governmet didn't raise taxes or cust other spending to finance the war, the famous Guns AND Butter choice.
The result of that policy was an understanding that the Dollar was in for trouble. The French started cashing Dollars into gold at $ 35/ounce, and the Gulf States forced the Oil companies to sell their concessions to the host countries at an oil price of aproximately $ 3/barrel. At the first opportunity, 1973 Yom Kippur War, they quadupled the price of oil, the first oil shock.
At this point the pent up inflation from the Vietnam War kicked in with avengence. We enbded up with over 12% inflation and interest rates went to the moon.
They say history repeats itself the first time as tragedy, the second time as farce. The currrent wars started by the previous administration clearly count in the farce category. These wars have produced the capital drain to China that will.inevitably end the same way as the Vietnam War caital drain. There will be a massive inflation and the Federal Reserve will end up raising interest rates to keep foreigners in Dollars, and the American People will pay severly for these crazy policies.
In the end the US will look like Britain in 1946.
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Adam Caper
Boston, MA
November 17th, 2009
8:57 pm
The irony is that we arrived at this current unhappy state of affairs because the Bush administration, so eager to be publicly combative in military adventures, failed over so many years to stand up to the more pressing international threat of China's chronic currency manipulation. Just as they put the Iraq and Afghanistan wars on a credit card, they also traded consumption forward to satisfy their lust for immediate gratification. (It's tempting to posit that the past decade’s orgy of consumerism was an intentional effort to distract Americans from the fact that those two wars were obvious disasters-in-the-making, but I'm not sure I'd credit that crew with that much foresight and organization. The Chinese government, on the other hand, surely understood that they were building a position what would pay handsome economic and geopolitical dividends for decades to come...those guys are pretty smart.).

The real problem is that now the Chinese have us by the short hairs. And given the propensity of the Idiot Wing to find any opportunity to manipulate the corpulent, semi-conscious heartland of our great nation for political gain, Obama -- who IS a long-term thinker, and who, we'll all recall, promised when he was a candidate to do what's good for us rather than what we might necessarily wish for at any given moment -- is going to face some pretty tough sledding at getting the US to hold the line on the interest rate issue.

The Chinese, by their nature, have discipline in spades (it helps not to see individuals as having any rights that can't be trumped for the benefit of the majority, but that's a separate topic). Our country, sadly, lately seems capable of having political will in foreign affairs matters only when we're out beating up on some country that we presume we can roll over with a relatively small number of troops and remote-controlled weapons.

The real task of statecraft, the real war with people who threaten our material well-being and who hold values violently in opposition to what we tell ourselves we stand for, happens of necessity in the background. It's undertaken by trusted leaders, who have the room to maneuver without idiots like Limbaugh, O'Reilly & Beck bloviating their constituents into an astroturf frenzy. FDR, Truman, Nixon, Reagan, Bush pere and even Clinton (to some degree) knew how to fight that war. It's hard to see that it would be possible today, and, sad to say, it's hard to have faith that Obama knows when to put away the love potion and pull out the big stick.
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4 .
Bob Sallamack
New Jersey
November 17th, 2009
8:57 pm
America leader in exports.

The business plan of American companies to export American jobs overseas began in 2002 and over 2 millions jobs have now been exported.

No other country in the world comes close to our lead in exporting jobs.

With every job in America that involves sitting in an office and using a computer and a telephone as a candidate for export overseas America will remain a leader for many years in this new area of exporting.
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5 .
former shareholder of a Hong Kong Bank
Hong Kong
November 17th, 2009
11:36 pm
The entire global economy has been based on the premise that toilet paper (ie the US dollar) provided the basis for sound economic progress and prosperity. That myth has now been "found out" and its just a question of time before all the major holders of this tissue (ie the Chinese, Japanese and Saudis etc) decide that toilet paper is an inappropriate vehicle for economic transaction.
It's worth noting that there are many observers who believe that a significant reason for the war in Iraq was Saddam's decision to sell his country's oil for euros rather than dollars.

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