22 China-US imbalances and Europe's fiscal crisis: Plus ça change?

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As the global crisis subsides, focus is shifting to the global imbalances. This chapter argues that China-US economic imbalances, and the challenge of managing them down politically as well as economically, are likely to become even more critical. It adds that the world can only hope that both sides will be up to the challenge.

Judging by the China-US two-step, in which the US first backed off criticizing China for its undervalued currency and now China has agreed to allow the renminbi to start rising against the dollar, one might think that that the longstanding tensions between the world's largest surplus nation, China, and the world's largest deficit country, the US, have abated to the point where they will not be an issue at the upcoming Toronto G20 summit and beyond.

But this apparent thaw in China-US relations belies the fact that what was already the most imbalanced economic relationship in history has become even more imbalanced during the current global economic crisis. While China's global surplus and the US's global deficit shrank substantially in 2009, China-US imbalances remained stubbornly high. With high unemployment in the US and rising social unrest in China, the political temptations to blame the other country for big problems at home are increasing. An appreciating renminbi will certainly help in the short run, but the longer term structural imbalances and the frictions they generate are not going away anytime soon.

The recent exchange rate politics are just the latest example of the general political trend in recent years in Sino-American relations. Through frequent high level beyond-closed-doors diplomacy, China and the US have managed down frictions over imbalances that are exacerbated by their fundamental differences in world views and their nascent geopolitical rivalry.

After the ravages of the global economic crisis, China-US economic imbalances and the challenge of managing them down politically as well as economically are likely to become even more important. Meanwhile, Europe's deep malaise—a weaker euro and stagnant European demand amid a sweeping fiscal crisis—provides a new set of challenges. The euro's swoon has decreased the competitiveness of Chinese exports in Europe.. Depressed European demand puts more pressure on the American consumer to become again the world's growth engine.

As a result, China and the US may pursue different objectives at the Toronto summit—even though they will no doubt be celebrating their bilateral currency win-win. The US wants Europe to keep stimulating demand in the short term, putting off fiscal consolidation. China's principal short term interest is in a stronger euro, which could be accomplished by tighter monetary policy by the European Central Bank.

Squaring the circle between these quite different American and Chinese approaches to the Eurozone crisis, which reinforce the divisions between Germany and other European nations led by France and Italy, will likely be a major focus of the Toronto G20.

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2009 was a diabolical year for the world economy. But there was supposed to be a silver lining—the global recession was supposed to reduce the massive imbalances between China and the US. Stagnant US consumer demand would slow the flood of Chinese imports. China's large scale fiscal stimulus plus bank lending boom would increase Chinese consumer demand for American exports. Given the uncertainties of the global economy, no one was surprised that China re-pegged the renminbi to the dollar. But American contraction and Chinese stimulus were nonetheless expected to cut into Sino- American imbalances.

China's global surpluses and America's global deficits did indeed shrink dramatically in 2009. China-US imbalances, however, were much more resilient. The result is that for both China's surpluses and the US's deficits, the role played by the other country was a much bigger part of the story in 2009 than even in 2008 (see Table 1).

Table 1. China-US Trade Imbalances

A. US Trade Deficits (billions $US)			
With:	**China**	**World**	**China/World**
2008	**268**	**816**	**33%**
2009	**227**	**501**	**45%**
Change	**-15%**	**-39%**	
http://www.census.gov/foreign-trade/balance/			
B. China Trade Surpluses (billions $US)			
With:	**US**	**World**	**US/World**
2008	**268**	**298**	**89%**
2009	**227**	**196**	**116%**
Change	**-15%**	**-34%**	
http://www.uschina.org/statistics/tradetable.html			

In 2008, America's trade deficit with China was $US 268 billion, one-third of its global trade deficit. The overall US trade deficit was cut by 40% in 2009. But its deficit with China only decreased by 15%. As a result the US's trade deficit with China was 45% of its trade deficit with the whole world in 2009.

This trend of more concentrated imbalances was even more striking from China's perspective. In 2008, 89% of China's trade surplus was with the US. In 2009, China's surplus with the whole world dropped by one third. But its surplus with the US only declined by 15%. China's surplus with the US in 2009 was bigger than its surplus with the whole world. Put differently, while China continued to run an enormous trade surplus with the US in 2009, its trade with the rest of the world was actually in deficit in 2009.

The bottom line from Table 1 is that American consumers were the port in the storm for Chinese exporters during the global trade cyclone of 2009. Turning to 2010, there is ample evidence that global trade is recovering. But there is no reason to think that this will decrease China-US imbalances.

The effects of the Eurozone crisis obviously extend far beyond Greece and the costs of bailing out its sovereign debt. As Figure 1 shows, the euro has depreciated more than 20% against the dollar in the past six months. Because China maintained its peg against the dollar until this week, the renminbi has also appreciated dramatically against the euro. Chinese exports have lost competitiveness in Europe, making American markets even more important to Chinese prosperity.

Figure 1. Euro and RMB exchange rates against the dollar

Source: http://research.stlouisfed.org/fred2/categories/94

In this new environment, there is no reason to think that China-US imbalances will decrease any time soon. In fact, America's trade deficit in China over the first four months of 2010 was $US 71 billion, 11% higher than for the comparable period in 2009. Over the same period, Chinese holdings of American Treasury bills, the capital account flip side of the US trade deficit, increased by 17% to $US 895 billion. First on the downside of the global recession and now as China and the US recover while Europe flounders, Sino-American imbalances seem an enduring part of the global economic landscape

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While the reality of China-US imbalances has not changed during the global economic crisis, the tone of China-US relations certainly has. Before the crisis, the US was wont to lecture and hector China over what Americans viewed as China's undervalued currency and unfair trade surpluses. The crisis could have intensified this dynamic. China went into the crisis worried that its thirty year growth miracle could be choked off by the collapse in global trade. The US entered into the crisis confident that it would bounce back quickly to remain the world's growth engine.

But China came out of the crisis arguably stronger and certainly more confident, while the US became less aggressive less convinced about the durability of its primacy. The result has been the kind of diplomacy evident at last month's Strategic and Economic Dialogue—American praise for Chinese stimulus and backing off regarding currency manipulation coupled Chinese assertiveness that it will manage its economy based on domestic considerations rather than American pressure.

It is against this background of enduring economic imbalance and new political balance that the future of China-US economic relations should be assessed. What needs to be done to bring balance to the economic relationship was made clear by Geithner and US Secretary of State Hillary Clinton before the July 2009 Strategic and Economic Dialogue:

We must take additional steps to lay the foundation for balanced and sustainable growth in the years to come. That will involve Americans rebuilding our savings, strengthening our financial system and investing in energy, education and health care to make our nation more productive and prosperous. For China it involves continuing financial sector reform and development. It also involves spurring domestic demand growth and making the Chinese economy less reliant on exports. (Wall Street Journal, 27 July 2009).

But this rebalancing requires changing the economic DNA of both countries, a task that is more likely to take decades than months. China must become more American by saving less and consuming more. America must become more Chinese by saving more and consuming less.

Just stablising US public debt after the full effects of the Obama administration's crisis fighting measures are felt is estimated to require tax cuts or spending increases of nearly one-third of central government spending. Americans have repeatedly shown that they will punish politicians for much less belt tightening than the US clearly needs.

What about tax increases, focusing on measures that would reduce future asset bubbles? Every dollar spent on servicing American mortgage debt is fully tax deductible. No US politician would commit the political suicide of suggesting America should wean itself off the motherhood and apple pie of government subsidised mortgages to realise the American dream of home ownership.

China's challenge is the mirror image of that facing the US. Whereas Americans borrow because they are confident about the future, Chinese citizens save for a rainy day. The Chinese government probably has the capacity to build an effective social safety net and to change the regulatory environment to favour the growth of retail banks, credit cards and insurance targeted at consumers. Indeed, it has taken important steps in this direction in recent years. But the overriding instinct of the government remains to use state-controlled banks to invest in infrastructure and state controlled companies rather than to empower the consuming middle class that might one day form the base for political liberalisation in China.

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The mismatch between the big changes needed to rebalance the American and Chinese economies and the immutable political constraints against doing so mean that it will always be tempting for both sides to blame each other for their economic problems. Up until now, China and the US have both largely resisted these temptations and managed down tensions in their relationship when they have flared up. The renminbi-dollar modus Vivendi is but the latest example.

But the more China rises towards becoming a genuine rival of the US, the longer America's current economic woes drag on, and the greater domestic unrest in China, the greater will be the diplomatic obstacles facing Beijing and Washington as they strive to keep driving forward their two decades of win-win economic engagement.

China and the US will come to the Toronto G20 meeting on the back of what amounts to a political love over the past month. However, the two countries have different interests regarding European economic policy. China wants the euro to appreciate to lighten the cost pressures on its exporters. The US wants Europe to put off fiscal consolidation to lighten the load on American demand as the engine of global growth.

These different positions are the direct result of the enduring imbalances between the American and Chinese economies. Toronto will prove yet another test for the management of Sino-American economic relations that will have global ramifications. The world can only hope that both sides will be up to the challenge and, based on recent history, there is reason to believe they will be.

About the Author

Geoffrey Garrett is founding CEO of the United States Studies Centre and Professor of Political Science at the University of Sydney. He was previously President of the Pacific Council on International Policy in Los Angeles and before that Dean of the UCLA International Institute. Garrett is author of *Partisan Politics in the Global Economy*, editor of *The Global Diffusion of Markets and Democracy*, both published by Cambridge University Press, and over fifty articles in the world's leading social science journals. A dual citizen of Australia and the US, Garrett was born and raised in Canberra and holds a BA (Hons) from the Australian National University. He earned his MA and PhD at Duke University in North Carolina, where he was a Fulbright Scholar.