The United States, China and the Global Economy

By

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The United States and China share several very important common economic interests that have gained substantial salience because of the global financial and economic crisis. This short paper will focus on four common interests: promoting global economic recovery, promoting fundamental reform of the major international financial institutions, enhancing the role of the G-20 in coordinating global economic policy, and reducing global economic imbalances.

According to calculations of the International Monetary Fund, among the developed country and emerging market economy members of the G-20 China and the United States have implemented the strongest stimulus packages to mitigate the effects of the global economic downturn. The first, and most important, common interest the two countries share is in encouraging other nations to follow their lead so that the prospects for early and strong global economic recovery are maximized. This common interest was reflected in actions and statements of the leaders of the two countries at the G-20 meetings in Washington last fall and in London this spring.

Second, both China and Washington share the common interest of promoting fundamental reforms of the major international financial institutions, especially the World Bank and the International Monetary Fund. The underrepresentation of China and other emerging markets such as India in the decision making process of these institutions is commonly referred to as the problem of “chairs and shares.” That refers to the domination of the executive boards of these institutions by advanced industrial nations and to the fact that in the weighted voting scheme in the IMF, for example, the weight of China is less than that of the Netherlands or Belgium. This despite the fact that the
Chinese economy is several times the size of these countries and that China’s trade for many years has dwarfed that of the Netherlands and Belgium. The United States, which has long had a voting share that is low relative to the size of its economy and its role in the global trading system, has supported an expansion of the shares of China and other emerging markets but the Europeans have steadfastly resisted and slowed such reforms.

Similarly the United States and China share a common interest in promoting the role of the G-20 in coordinating the global response to major international economic issues. Historically the G-7 (and its antecedents the G-5, etc.) had played this role. But over the last decade or so, as the share of global economic output and trade accounted for by emerging markets grew significantly, it was increasingly clear that the G-7 was no longer an effective coordinating mechanism. Countries producing about half of global output (measured in PPP terms) were entirely unrepresented in the G-7 discussions. Attempts to remedy this by inviting, on an ad hoc basis, additional countries to participate in specific G-7 meetings, without really adapting to changes in the underlying economic reality, were doomed to failure. It is particularly to China’s credit that over recent years it steadfastly resisted periodic attempts of members of the G-7 to bring China into the G-7 discussions on a more systematic basis. It quite understandably did not want to play a major role in an international institution in which it was, in effect, the sole representative of a huge number of emerging market economies. The G-20, which includes in addition to China, Brazil, India, Indonesia, and so forth, is a much more suitable structure from the Chinese perspective. And the United States, relatively early compared to most other G-7 countries, also embraced the shift to the more inclusive structure of the G-20.
Third, the United States and China share a strong common interest in avoiding trade protectionism, not only during the current global economic crisis, but on a more enduring basis as well. This objective was strongly supported by both countries at the G-20 leadership meetings in Washington in the fall of 2008 and in London in the spring of 2009. Leaders from both countries in their public statements between the two meetings and since the spring G-20 leaders meeting have continued to speak out strongly about the importance of working toward this common objective. The United States, as the world’s largest trading country clearly has an important stake in maintaining trade openness, particularly during the downturn. And China, as the world’s third largest trading country and (since last fall when it went ahead of Germany) the world’s largest exporter, has an even greater interest in this objective.

Fourth, both countries have a strong common interest in reducing global economic imbalances. China’s global current account surplus expanded from only $17 billion and 1 percent of gross domestic product in 2001 to $372 billion and 11 percent of gross domestic product in 2007. That made China by 2007 far and away the world’s largest global surplus country. Indeed, as a share of total output no other large trading country has ever had a global current account surplus even remotely approaching that of the size of China’s surplus in 2007. China’s goal of reducing this very large imbalance in its international accounts was clearly reflected by the statement of Premier Wen Jiabao at the time of the meeting of the National People’s Congress in the spring of 2007. China, he said, “must reduce its excessively large trade imbalance.” Over roughly the same period the United States became far and away the world’s largest global deficit country.
The U.S. current account deficit peaked at almost $800 billion or 6 percent of GDP in 2006, a level unprecedented in recent decades.

In the view of many observers these large global economic imbalances, if not the primary cause, certainly contributed to the current global financial crisis. China’s national savings rate soared over the decade from about 38 percent in 2001 to more than 53 percent of GDP by 2008. No other country ever has recorded either such a large increase in such a short period of time or such a high rate of national savings. Even though China’s investment rate for much of the decade was the highest ever recorded by any country (continuously more than two-fifths of gross domestic product starting in 2003 and continuing through 2008), as a result of the massive increase in the savings rate to an unprecedentedly high level, China had an increasingly large surplus of savings over investment. This necessarily was loaned to the rest of the world, including the United States, through the accumulation of huge official foreign exchange reserves.

The rise of the national savings rate in China was mirrored by the decline in the national savings rate in the United States. China, a relatively low income country, surprisingly became the world’s largest creditor country while the U.S., a relatively high income country, became the world’s largest debtor country. The large volume of lending by China to the United States, in the form of purchases of U.S. government and agency debt as well as U.S. corporate debt, put downward pressure on U.S. interest rates, facilitating the accumulation of increasing debt that U.S. households incurred to support what can clearly now be seen as excessive consumption expenditures. And the low interest rates led financial institutions, which were searching for higher yield, to introduce increasingly complex financial products in a process that was described initially as
“financial innovation” but which we can now see was one of the principle causes of the 
global financial crisis. In short, large capital inflows into the United States contributed to 
the build up of excess leverage both by households and by financial institutions and the 
under pricing of risk. Failures on the part of U.S. financial regulators, notably the U.S. 
Federal Reserve, clearly are the most important cause of the global financial crisis, but 
the emergence of huge global economic imbalances over the years preceding the crisis 
was an important contributory factor.

Some progress in U.S.-China cooperation, either explicit or implicit, has already 
been made on the issues discussed above. Based on official data on economic 
performance in the first quarter of 2009, it appears that China’s strong stimulus program 
has already led it to be the first major economy to begin to recover from the global 
economic downturn. It is serving as a powerful example that a large, well timed, and 
well designed stimulus program can indeed contribute to a recovery of economic growth.

The crisis has led to some modest acceleration of the process of considering 
reform of “chairs and shares” of the major international financial institutions. This 
progress was particularly evident in the joint statement following the G-20 leaders 
meeting in London in April 2009. Similarly the success of those meetings has clearly 
established the G-20 as the major international forum for addressing major global 
economic issues.

Finally, there appears to be at least some progress on addressing global economic 
imbalances. The depreciation of the U.S. dollar by about 30 percent on a real, trade-
weighted basis between February 2002 and the middle of 2008 contributed to a marked 
reduction in the U.S. external deficit. After peaking at 6 percent of GDP in 2006 the
current account fell to $675 billion and 4.7 percent of GDP in 2008. The IMF forecasts that it will fall further, to only 2.8 percent of GDP, this year.

A similar development is beginning to emerge in China. China’s currency appreciated only very modestly in the first two and half years after its new foreign exchange regime was introduced in the middle of 2005. But in 2008 China’s currency appreciated much more rapidly. Indeed according to the calculations of the Bank for International Settlements from July 2005 through the end of 2007 China’s currency appreciated cumulatively by only 6.5 percent, while in 2008 alone it appreciated by 13 percent. Not surprisingly, since its currency was very undervalued in mid-2005 and the initial pace of appreciation was minimal, China’s current account expanded massively up through 2007. But with much more rapid currency appreciation beginning in 2008 China’s current account surplus grew much more slowly in absolute terms, by only 15 percent in 2008, and fell as a percent of GDP to 9.8 percent, the first decline in almost a decade. If China’s currency continues to appreciate over the course of this year its current account surplus as a share of GDP could decline by another percentage point or so.