



## Is China Stepping Up to the Plate?

*Nicholas R. Lardy says that China is moving aggressively in response to the global economic crisis, but that Chinese leaders remain wary of asserting themselves on the world stage.*

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Nicholas Lardy, senior fellow at the Institute, is here on Peterson Perspectives to answer questions about China and its latest statements and actions with reference to the global economic crisis. Thanks for joining us, Nick.

Nicholas R. Lardy: Thank you, Steve.

Steve Weisman: We're speaking today a little bit before the G-20 meeting. There has been a flurry of comments that suggest some irritants between the United States and China, including some Chinese comments expressing perhaps some doubt about the value or security of United States Treasuries. What's China up to these days when you look at how they're facing their global responsibilities and obligations in the G-20?

Nicholas R. Lardy: In this area, I think China has become quite concerned over the last few weeks as the size of the US budget deficit has become clearer. They're worried obviously, not that the United States is going to default on its obligations, but rather when the bonds they hold mature, that they may have substantially less purchasing power because of a high rate of inflation that might emerge in the United States. Obviously, that's not a risk today with the slump, but it could be when two or three years from now as we come out of the slump and there's a much-bigger overhang of government debt. The worry is that we could experience much higher inflation.

I think that's the background factor. They said a few things about this long ago but the dial has been turned up quite a bit in recent weeks as massive, massive US government deficits for both 2009 and then for next year as well have become clear.

Steve Weisman: Were the Chinese also expressing a certain amount of displeasure, responding to Treasury Secretary Geithner's comments in January, about using the word "manipulation" to characterize Chinese actions on their own currency?

Nicholas R. Lardy: Possibly. But I think that was mostly smoothed over in the days right after the statement about manipulation was made. Remember the White House spokesman immediately came out and said that Mr. Geithner's comment was taken from some political campaign statements and statements made during the campaign were not necessarily current US government policy. Then there were some phone calls back and forth between President Obama and the Chinese president, Secretary Geithner and the Chinese vice premier in charge of the financial sector. So, I think they smoothed that over earlier before these more recent statements.

Steve Weisman: But the Chinese have always been somewhat irritated over US calls for the renminbi to appreciate. Was that also behind their concern about the value of US treasuries? In other words, are they worried that the dollar will depreciate?

Nicholas R. Lardy: Well, I think they're worried that the dollar might depreciate. But beyond that they're worried that inflation could erode the value of the dollar. Quite frankly, some of their statements come out of a sense of frustration that they face a series of choices, none of which is ideal from their point of view. One solution would be, if they had allowed their currency to appreciate a lot more over the last few years, they wouldn't have had to intervene in the currency markets and they would not have piled up this big amount of foreign exchange reserves of roughly \$2 trillion today.

Alternatively, they could have liberalized more on capital outflows so that the big surplus on trade would be offset with a capital outflow. They've started to do that but they didn't get really going on that program early enough.

So, they're really stuck with the third alternative, which is the one they're in. And that is to continue to intervene, control the extent of appreciation for a variety of reasons, and then have very massive additions to their foreign exchange reserves, which then they have to turn around and worry about how much they're going to be worth down the road. So, I think some of the statements reflect the fact that they don't really like any of those choices.

Steve Weisman: You've written that the Chinese stimulus program is very ambitious and also appears to be directed toward the kind of rebalancing of the Chinese economy that you and others have advocated. Can you explain that a little bit, please?

Nicholas R. Lardy: Well, the stimulus package is very aggressive. It's very large. It's one of the largest in the world, according to the estimates of the International Monetary Fund. But it is not just a pure investment program, although the investment component is significant. They're also having a very substantial increase in social outlays, increasing expenditures on health programs for example, trying to bring an additional 400 million people into the health insurance scheme. And the reason this would help to contribute to rebalancing is that the whole idea of rebalancing is to have more consumption-driven growth, by which I mean China would rely less on having a high rate of investment and running up a bigger and bigger trade surplus and would rely more on generating growth by having more private consumption. Private consumption has languished in part because the social safety net has become rather frayed over the last decade.

And so improving the health insurance scheme for 400 million people is a way of perhaps reducing what economists call the precautionary demand for savings. The reality in China is that you can't even get into a hospital unless you pay cash in advance. So if you don't have insurance, you're going to save a lot of money so that if you get sick or one of your family members get sick, you can have access to medical care. And with the government stepping in to provide more of this directly through various insurance schemes, people may have enough confidence not to save quite so much and spend a bit more. And that would help to redirect the economy more toward consumption-driven growth.

So, they're not only trying to keep the growth rate from falling too far, although it has fallen quite a bit, but they're also trying to lay the foundation for more balanced economic growth as they come out of the recession.

Steve Weisman: Is China getting the respect or appreciation that you think it deserves from the other members of the G-20 going into the London Summit?

Nicholas R. Lardy: Secretary Clinton, when she was in China last month, did praise China for its very large stimulus program, welcomed it, and of course one major goal of the United States is to get other countries, other members of the G-20, to increase their programs so that there is more global coordination in this area.

China, in its own position paper for the G-20, has called as its number one priority the coordination on these fiscal actions. So it implicitly is supporting the United States but they don't want to be too much out in front. They're very happy to be in the G-20. I think they're very happy that the G-20 has become de facto the leading organization for guiding policymaking on global economic issues. But the Chinese still have a reluctance to lecture, if you will, or advise other countries too strongly what to do. Their leadership is more by example, in part because they fear other countries may tell them what to do in areas that they regard as purely domestic, for example, how they should deal with Tibet or human rights or other issues. So, China has, even though its program is very strong, a relatively low profile going into the meeting.

Steve Weisman: Within the G-20, there's a lot of talk that there's a kind of core G-2 relationship between the United States and China. The United States and China are undertaking what appear to be the two most aggressive economic recovery programs. Do you think there is going to be a G-2 emerging out of the G-20 despite what you earlier said was a Chinese reluctance for an overly high profile?

Nicholas R. Lardy: Well, there could be a kind of informal, de facto G-2. I don't think there's going to be an explicit, formal G-2 for the reason that I alluded to: the reluctance of the Chinese to assume a major global leadership role at this point.

They're not only worried about the fact that, if they give advice, they may have to listen more to other countries advice. They also fear that they will be held to too high a standard. They're still a country with a per capita income of about \$3000. If they're in a G-2 with one of the wealthiest countries in the world, that may at some point require them to take actions that they think are inappropriate, given the fact that they're still a low- or middle-income economy, not an advanced, industrial economy. So, that's another source of uncertainty, I would say, in terms the way the Chinese would think about a G-2.

Steve Weisman: What's the latest outlook for the Chinese economy?

Nicholas R. Lardy: Of course, their exports, after some delay now, have begun to soften quite significantly. There's a lot of unemployment in that sector. But their stimulus package is very strong, and most importantly their banks are increasing their lending. This is quite different from the situation in the United States and many

other industrial countries. And I think the combination of the fiscal stimulus, including its social safety net component, and this seemingly quite successful monetary expansion will allow them to keep the growth rate in the neighborhood of 7 percent, maybe in the range of 7 to 8 percent.

Steve Weisman: Would an increased growth rate like that cause the Obama administration to back away from some of the tough rhetoric that was implied during the campaign and even implied by the Geithner statement, although as you said that was softened somewhat? What are the prospects for US-China cooperation in the next few months?

Nicholas R. Lardy: I think in theory they should be very good. China does have a very strong stimulus program. The United States has indicated that as its number one priority for the G-20 meeting. So China has stepped up to the plate in a way that no other developing- or developed-country member of the G-20 has done.

They've also had what I would call a stealth appreciation. Their exchange rate in the last six to nine months has been fixed against the dollar at an unchanged rate. But since the dollar has been appreciating over this period fairly strongly, the Chinese currency in a trade-weighted basis has actually appreciated more in the last year than at any other time since they adopted their new currency policy in the middle of 2005.

I would think, between contributions that China is making to global recovery on the stimulus side and the fact that the pace of appreciation has increased significantly, that the Obama administration would be pretty reluctant to have the Treasury identify China as a currency manipulator. I believe they're required to make a report to Congress officially on April fifteenth, although it sometimes slides. But when that report comes out in a little less than a month, or maybe a month from now, I would be surprised if China is named as a manipulator.

Steve Weisman: That would be interesting because if it is not named as a manipulator, that might irritate some in Congress.

Nicholas R. Lardy: Well, there are certainly many people, particularly in the Democratic Party, hoping that Obama would take a tougher line than the previous administration on this issue. But as the global situation has changed quite dramatically, appreciation has accelerated. And in the last month or so, Chinese reserves are actually going down rather than going up as a result of some capital outflows. So the kind of macroeconomic exchange rate situation is evolving fairly rapidly.

Steve Weisman: Nick Lardy, thank you very much for sharing your thoughts today on Peterson Perspectives.

Nicholas R. Lardy: Thank you, Steve.

