



Geithner in China: What Are the Prospects?

Nicholas R. Lardy concludes that US-China economic tensions have eased but that the new Treasury Secretary has important items on his agenda to discuss in Beijing.

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest, Nicholas Lardy, senior fellow at the Institute, is here to talk about Treasury Secretary Timothy Geithner's trip to China at the end of May, the secretary's first visit to Beijing as treasury secretary. Thanks for joining us today, Nick.

Nicholas R. Lardy: Thank you, Steve.

Steve Weisman: By the way, Secretary Geithner was quoted in the *New York Times* recently as saying that he pays careful attention to the views of Nick Lardy.

How important is this visit?

Nicholas R. Lardy: I think it's very important because this is preparation for the first iteration of what is being called the new Strategic and Economic Dialogue that will convene in Washington in the third week of July. It will be cochaired on our side by Secretary Clinton and Secretary Geithner. Secretary Clinton has already made a very successful trip to China. Secretary Geithner has been preoccupied with domestic financial matters and hasn't had an opportunity yet to pay a visit to China but I believe he certainly regards this as a very important set of talks, not only to deal with global economic issues but to set the scene for the dialogue that occurs in July.

Steve Weisman: What are the major problems that Secretary Geithner needs to address on this trip?

Nicholas R. Lardy: I think he would want to share views with the Chinese leadership about the current state of the global economy, the nature of the recovery process that seems to be underway already in China. I think the Chinese leaders will also be very anxious to hear from him about the kinds of regulatory changes that are going to be introduced in the United States in the wake of the financial crisis. How are we going to try to manage financial institutions, banks, and a variety of other institutions more effectively than obviously was the case in the run-up to the crisis? The Chinese are always very interested in understanding what other countries are doing so they can draw lessons for their own situation and take appropriate action. Of course, they've been blessed by the fact that they had a stricter regulatory regime and did not allow their financial institutions to engage in most of the kinds of transactions that were being done in the

United States. So they are in a very good position, but they're always looking to improve it. So I'm sure they want to learn more about the secretary's plans for reform of the financial regulatory system.

Steve Weisman:

The Chinese have fired what some have interpreted to be a couple of warning shots across the bow of the Obama administration, notably when they've expressed concerns about the safety of US Treasury securities, of which they own a large number. What is the state of play on that issue?

Nicholas R. Lardy:

The state of play is, as you suggest, the Chinese are holding probably something on the order of \$1.5 trillion in dollar-denominated financial assets, a large portion of them issued by the US government. They have been a big financier of our external deficit over the last few years. This administration and its predecessor have been interested in taking steps to ensure that that flow of funds from China would continue, and so have tried to reassure that Chinese about the value of those securities. And again, I think, the Chinese will press for the plans for reducing the budget deficit in the United States going forward, bringing our large government debt more under control so that the prospect for inflation and the decline in the purchasing power of the dollar is reduced. And that certainly would be very high on the agenda. I think it's a genuine concern on the part of the Chinese. It's obviously a concern on the part of all investors in the US government bonds as we've seen the spread between shorter-term bonds and longer-term bonds has widened dramatically in recent times because of this widespread apprehension that inflation could pick up. Not today or tomorrow, but once we start coming out of the doldrums, inflation could be a much more serious factor.

Steve Weisman:

Beyond the assurances that Secretary Geithner will be providing, what's appropriate for him to say in terms of whether he requests, implores, suggests that the Chinese continue to buy these securities?

Nicholas R. Lardy:

I doubt that he's going to implore. In the end, the Chinese will make their own judgment about what the best currency distribution of their reserves is. They are very heavily in dollars. I think they're likely to remain heavily in dollars but he can try to increase the comfort level. I mean, the good news is that the US external deficit, as opposed to the domestic deficit, the external deficit has been shrinking significantly in recent years. The peak was in 2006, when our external deficit was equal to 6 percent of GDP. By 2008, it was down to under 5 percent, 4.7 percent I believe, and this year it's going to be in the neighborhood of 3 percent, maybe slightly less. So the need of the United States to sell financial assets, that is, to borrow from other countries is going down slightly. But there's still a big focus on this because it's not just that we want the Chinese to keep buying even though it might be at a slower pace. We want them to continue to hold the mass of stock of dollar-denominated financial assets that they already have in their reserves, because if they were to begin selling them off, it could lead to a very sharp decline in the value of the dollar and a spike in interest rates, which would be extremely detrimental at the present time in terms of the policy toward economic recovery in the United States.

Steve Weisman: Do you see any contrast between how this treasury is handling this issue and the way Treasury Secretary Hank Paulson did when he was treasury secretary?

Nicholas R. Lardy: I think there are certainly some elements of continuity and also some differences. The biggest difference, of course, is that we're now well into a global economic slump, and that was just barely beginning under Secretary Paulson's watch. Now, we also see that the Chinese have begun their recovery already. So I do think the dynamic in the relationship inevitably changes somewhat; it is somewhat more a relationship of equals, not that the United States and China are remotely equal economically. But the gulf between them I think in effect has been reduced by virtue of the fact that our economy is still shrinking, while theirs is growing. They had a financial system that did not implode. We led the globe into the global financial crisis because of our failures in the regulatory regime and so forth.

So Secretary Paulson was quite free with his advice about how the Chinese should reform their financial system. They mostly rejected it. I don't think Secretary Geithner or any other finance minister from any other advanced, developed country could go to China these days and with a straight face give them advice about how they should reform their financial system. So I think it is, as I say, more of a relationship of equals, in part because of how well China is doing, both in terms of economic growth and in terms of the ability of their financial system to weather a rather severe storm.

Steve Weisman: I'm asking about what is said and left unsaid in diplomatic exchanges. When Secretary of State Clinton was in China earlier this year, she seemed to suggest that the United States did not want China to reduce its holdings of dollar-denominated assets. That struck many analysts as an unusual thing for a secretary of state to be commenting on. How did it strike you?

Nicholas R. Lardy: I do think the conventional pattern is to let the treasury secretary take the lead on all questions having to do with the dollar, the strength of the dollar, and related issues. Similarly the treasury secretary defers to the secretary of state on issues that are clearly exclusively in the foreign policy domain. So, I think it was a little bit unusual, but she was in effect saying what everybody recognizes. A little unusual perhaps to hear it from a secretary of state, but certainly it was consistent with the real situation.

Steve Weisman: What's your perception of how this administration has reconciled the twin poles, if you will, of treasury and state as the lead player on China policy after what I think was a period in the latter part of the Bush administration when treasury had the lead.

Nicholas R. Lardy: Remember you have to think back on the conditions under which Mr. Paulson was recruited to come to Washington. He wanted and was given a mandate to take the lead on the US relations with China, or at least a very broad spectrum of the relationship. He personally had a very strong interest in energy policy and conservation, and he built that into the Strategic Dialogue. In effect, he pulled away some of the issues from other departments and built them into the dialogue that he established, and he was, according to the White House,

the president's personal representative in this relationship. He was not just the secretary of the treasury, he was also the president's personal representative to China, and that gave him a very broad mandate. The current treasury secretary does not have that mandate. The dialogues that used to be run separately by treasury and state are now being merged into one combined event that's going to be bureaucratically more complicated. It's going to have two "chairs" on each side. It's going to meet once a year instead of twice a year, and there are a lot of details to be worked out about exactly how the agenda for these meetings will be structured. But it will engage in a very, very broad range of things; obviously, economics, finance, but also Korea, global warming, and a range of other global issues.

Steve Weisman: Now, Treasury Secretary Geithner comes though with one very interesting strength that no one, I think, in that job has had: He has lived in China and he speaks Mandarin, or at least understands it according to some accounts. How do you think, after his early stumble saying that China was manipulating its currency and then pulling back, that he's going to be received?

Nicholas R. Lardy: I think he will be very well received, just as Secretary Clinton was well received. The Chinese for a number of years now have placed a very high priority on having a productive, constructive relationship with the United States. I think that they're going to continue to pursue that and so they're going to treat Secretary Geithner very well, though the White House did explain that the campaign statements that he used to answer some of the congressional questions were not a reflection of administration policy. And when the treasury issued its first formal currency report on April fifteenth this year, they did not name China as a manipulator. So there was a stepping away from the statements that the secretary had submitted in writing to the Senate committee that was confirming him. I think he's in relatively good shape, and I think he will conduct himself extremely well and be very well received by the Chinese.

Steve Weisman: Nick Lardy, thank you very much, and of course I hope you come back and we can assess how we did after the trip or subsequently.

Nicholas R. Lardy: Good. I look forward to it.

Steve Weisman: Thanks.

