Mitchell's Musings 10-21-2013: Would They Put Their Money Where Their Mouth Is?

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Here (below) is an excerpt from a recent *Los Angeles Times* article, one of many dealing with the current[1] impasse in Washington over the government shutdown and the debt ceiling:

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> ***Upset over U.S. fiscal crisis, China urges a "de-Americanized world"***
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> *By Jim Puzzanghera*
>
> *October 14, 2013*
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> *WASHINGTON -- Upset that the fiscal stalemate in Washington is threatening the global economy, China called for the U.S. dollar to be replaced as the international reserve currency as well as for broader steps to create a "de-Americanized world." China also called for an end to the "pernicious impasse" in the U.S. over the raising the debt limit and ending the partial government shutdown, saying the world needed another reserve currency so nations could protect themselves "from the spillover of the intensifying domestic political turmoil in the United States."*
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> *Most countries hold their foreign exchange reserves in U.S. dollars because the currency is viewed as the world's most stable. China is the largest foreign holder of U.S. debt, with about $1.3 trillion in Treasury bonds, and is concerned about the impact of a U.S. failure to raise the debt limit on those holdings...*[2]

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There are few bright sides to the current Congressional impasse and many more downsides. Were China to really start dumping its Treasury securities and other dollar-denominated holdings, there could be a financial panic with obvious bad results for the U.S. and world economies. But a "de-Americanized world" could be a long-term Good Thing for both the U.S. and China. If China really moved toward de-Americanization – if it put its money where its mouth is – that shift could be a good outcome of the impasse.

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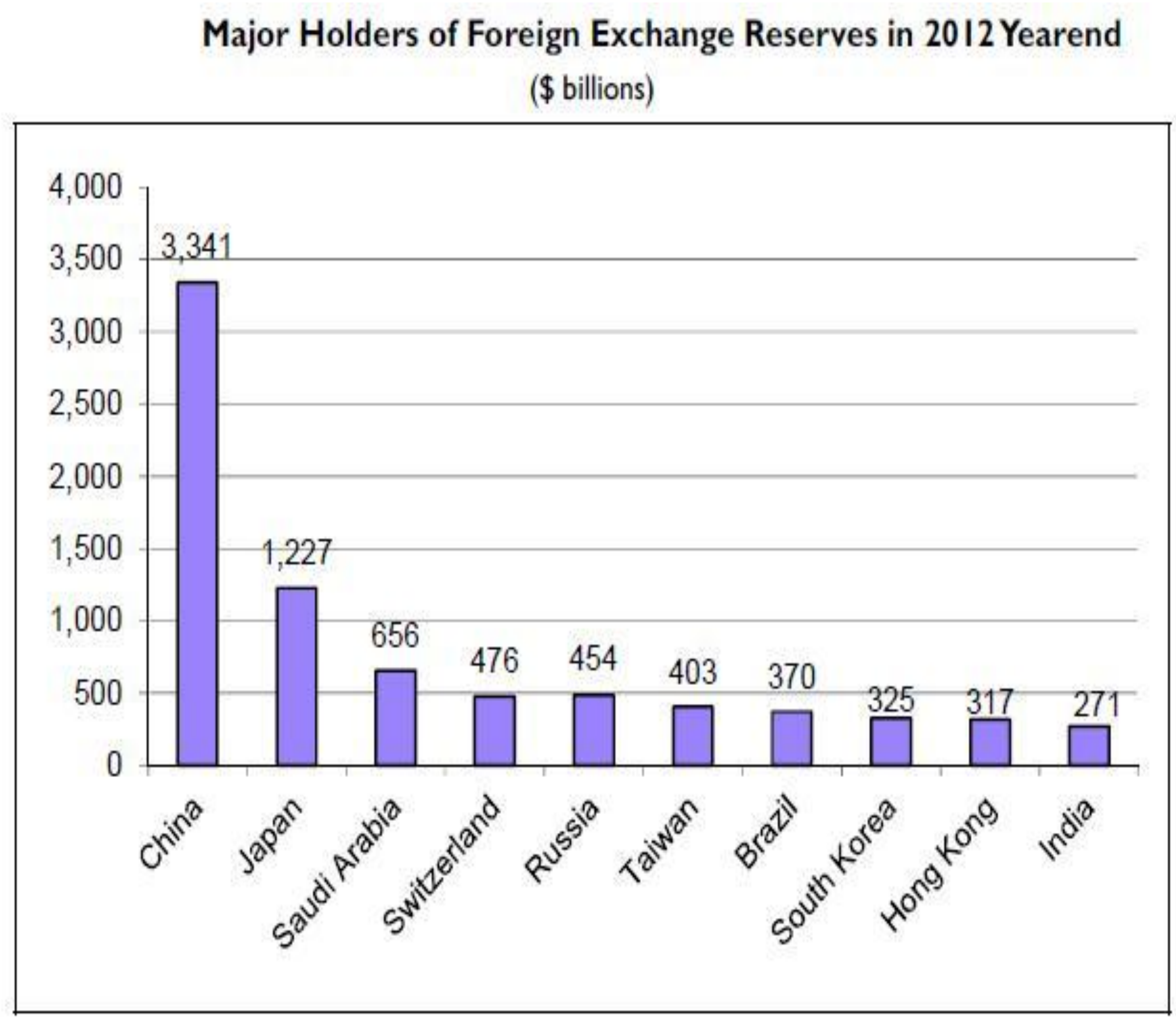
[1] This musing was posted October 15, 2013.

[2] http://www.latimes.com/business/money/la-fi-mo-china-debt-limit-shutdown-de-americanized-economy-20131014,0,1990632.story

One bad side of the current government shutdown is that many federal statistical websites are either not providing data or are operating only in a limited capacity. But let's look at some data sources that are available. Consider China's foreign exchange reserves. Chinese official policy, accomplished by exchange rate intervention and controls, is to run a net export ("trade") surplus, especially with the U.S. In effect, China's policy developed as an imitation of Japan's, but in absolute terms, China has outperformed its mentor in modern mercantilism. As the chart below shows, China holds huge reserves compared even with Japan's.[3] Basically, if you chronically sell more than you buy, you end up holding more and more financial assets.

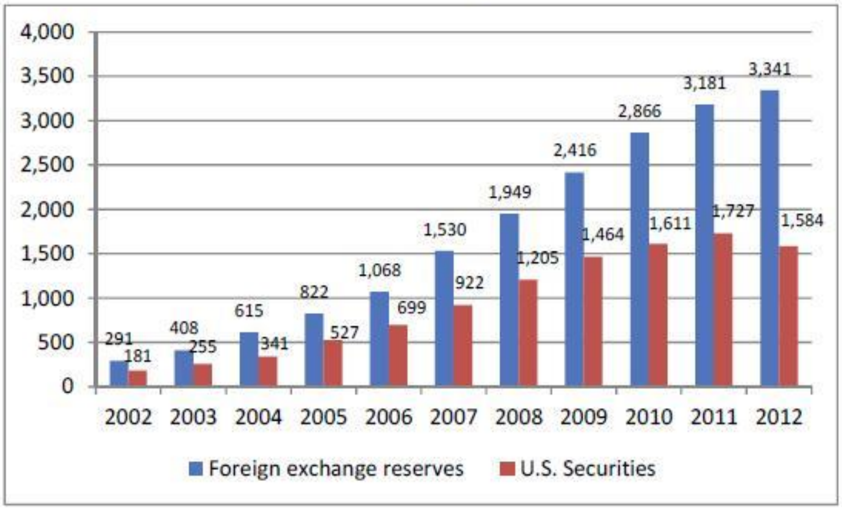


Almost half of the reserves accumulated by China are in dollar-denominated securities as the chart on the next page shows.

[3] That chart and the next two charts below come from a report by the Congressional Research Service available at: http://www.fas.org/sgp/crs/row/RL34314.pdf

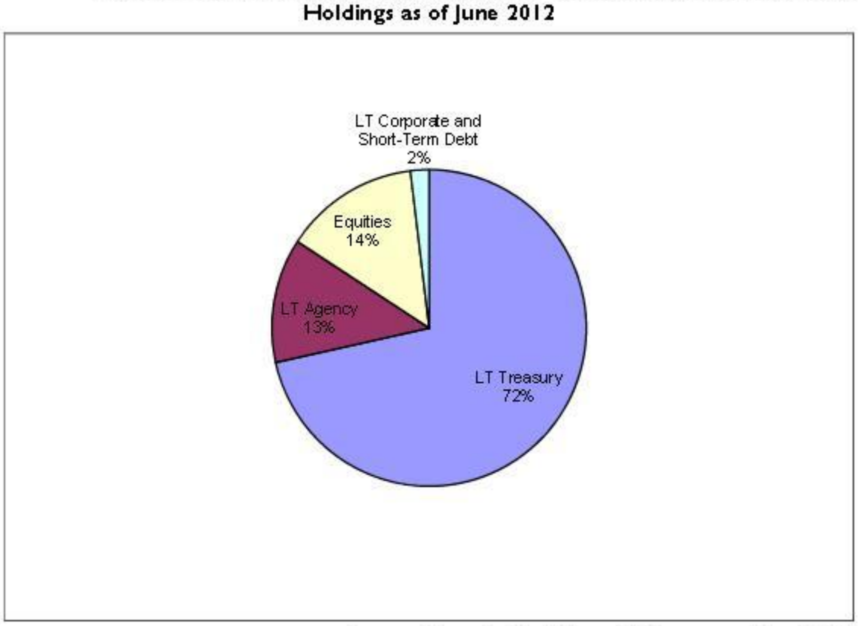
China's Foreign Exchange Reserves and Holdings of U.S. Public and Private Securities: 2002-2012

($ billions)



Seven out of ten dollars of Chinese reserves are in U.S. long-term Treasury securities and still more is held in securities issued by other federal agencies.

China's Holdings of U.S. Securities by Major Category as a Percent of Total Holdings as of June 2012



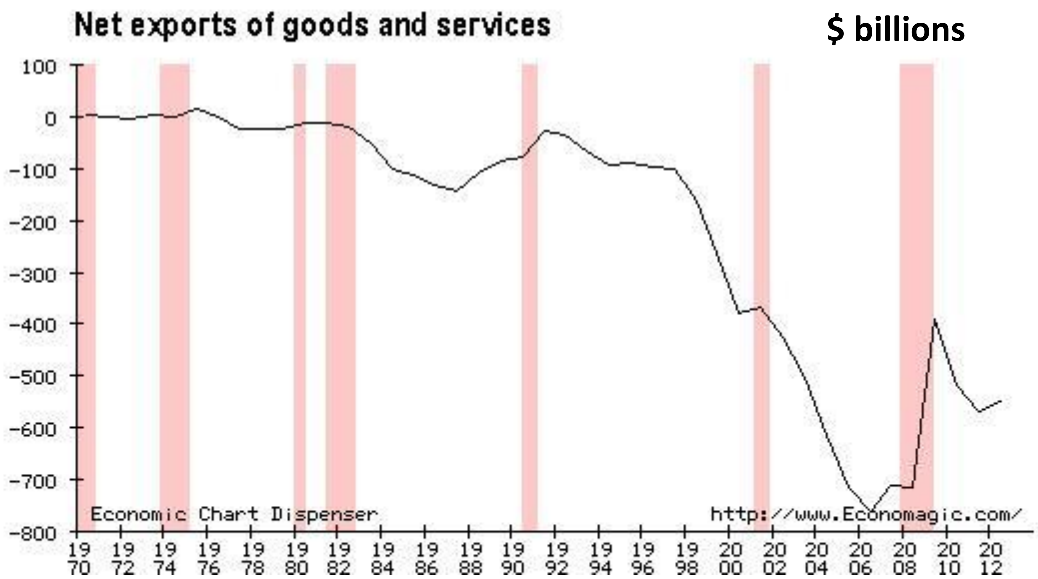
Source: U.S. Department of the Treasury, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.

In short, so far, China has in fact gone along with an Americanized world economy, largely because it wants to continue running trade surpluses with the U.S.

If China were serious about de-Americanizing, it could not continue to follow such a mercantilist policy simply by switching to some other currency. The options are too limited. A jump into the euro for example would mean a big drop in the dollar's exchange rate and a rise in the value of the euro, i.e., Europe would have to play the game that the U.S. has – allowing itself to run huge trade deficits with China. Given the weak state of the European economy, such acquiescence by the Europeans seems most unlikely.

China probably would not want to anoint the yen as its reserve currency because of lingering resentments of Japan that go back to World War II. And Japan – the Chinese mentor for running trade surpluses – wouldn't be willing. So de-Americanizing in the end would mean ceasing to run trade surpluses with the U.S. and abandoning mercantilism. Although the ruling elite in China evidently thinks it benefits from a mercantilist policy, it seems likely that the bulk of the Chinese population would ultimately benefit from a system in which more of Chinese production stayed home and imports were less costly to obtain. More of the population might then enjoy the flat screen TVs and cell phones they currently produce in exchange for U.S. Treasuries.

There is no natural law that the U.S. has to run a trade deficit or that its manufacturing sector has to be outsourced abroad. As the chart below indicates, trade was roughly balanced until the 1980s. But the real downward spiral occurred as China came onto world markets in the 1990s.



The Great Recession – which cut back on U.S. imports as consumers and businesses retreated – led to a less negative U.S. net export balance. But the current deficit, about half a trillion dollars, is about four percent of GDP. So a move simply to balanced trade in the U.S. would be far more stimulatory than any other policy applied since the downturn. The job creation would dwarf anything previously implemented. And many of those jobs would be in the manufacturing sector simply because of the composition of U.S. exports and imports.

Now I know that someone out there will want to tell me stories about saving rates in the U.S. (or lack thereof) as the “true” cause of the trade deficit. But anyone who wants to do so will first have to explain how a continuous U.S. trade deficit and the piling up of net liabilities to the world (including China) could occur *and be sustained for as long as it has*. It couldn’t happen unless other countries insisted on running trade surpluses with the U.S., insisted on holding the resulting U.S. liabilities, and – in short – insisted on having an Americanized world economy. When that insistence ends, we will see the end of the seeming natural law that the U.S. must run a trade deficit forever. If China is truly retreating from that insistence, and if it makes the change in policy gradually to avoid a financial panic, both sides of the Pacific will benefit.