Worksheet 23.3

Excuse me, China, could you lend us another billion?

American consumers are a curious bunch. Up until 2007, the average savings rate in the United States fell as low as 1%, and during brief period was actually negative. What does negative savings actually *mean?* It means that Americans consume *more* than they actually produce.

On the micro level, the only way to consume beyond ones income is to borrow from someone else to pay for the additional consumption. In other words, savings must be negative for one to consume beyond his or her income. The US is a nation of borrowers, but from whom do we borrow? China, for one.

China is a nation of *savers*, where national savings averages 50% of income. What exactly does this *mean?* Well, just the opposite what negative savings means; rather than consuming more than it produces, the Chinese consume only about half of what it produces. Here's how James Fallows, a Shanghai-based journalist, explains the China/US dilemma: read from 'Any economist will to 'as China does' in the article, 'The $1.4 trillion question'.

What happens to the rest of China's output? Naturally, it's shipped overseas for Americans and others in the West to consume. The irony is that the consumption of China's products has been kept affordable and cheap thanks to the actions the Chinese government has taken to suppress the value of the RMB, thus keeping its products cheap and attractive to American consumers. Read from 'When the dollar is strong' to 'New England' in the article linked to above.

Clearly, a strong dollar is good for America in many ways. The dollar's strength in the last decade can be credited partially to the Chinese, who have been buying dollar denominated assets in record numbers over the last seven years.

> *By 1996, China amassed its first $100 billion in foreign assets, mainly held in U.S. dollars. (China considers these holdings a state secret, so all numbers come from analyses by outside experts.) By 2001, that sum doubled to about $200 billion… Since then, it has increased more than sixfold, by well over a trillion dollars, and China's foreign reserves are now the largest in the world.*

'The $1.4 trillion question'

China's purchase of American assets keeps demand for dollars on foreign exchange markets strong, thus the value of the dollar high relative to other currencies, allowing American firms and consumers the benefits of a strong dollars described above.

A nation's balance of payments consists of **the current account**, which measures the difference between a country's expenditures on imports and its income from exports (*In 2008 China had a $232 billion current account surplus with the US, meaning the US bought more Chinese goods than China bought of American goods*), and **the financial account**, which measures the difference between the inflows of foreign money for the purchase of real and financial assets at home and the outflows of currency for the purchase of foreign assets abroad. In the financial account, China maintains a deficit (*meaning China holds more American financial and real assets than America does of China's*), to off-set its current account surplus.

The two accounts together, by definition, balance out…usually. Any deficit in the China's financial account that does not cover the surplus in its current account can be held as foreign exchange reserves by the People's Bank of China. The PBOC, however, prefers not to hold excess dollars in reserve, as the dollar's value is continually eroded by inflation and depreciation; therefore it invests the hundreds of billions of excess dollars it receives from Americans' purchase of Chinese goods back into the American economy, buying up American assets, with the aim of earning interest on these assets that exceed the inflation rates.

The 'assets' the Chinese are using their large influx of dollars to buy are primarily US government bonds. The government issues these bonds to finance its budget deficits, and the Chinese are happy to buy these bonds for a couple of reasons: They are secure investments, meaning that unless the US government collapses, the interest on US bonds is guaranteed income for China. That's one reason; but the primary reason is that the purchase of these bonds puts US dollars that were originally spent by American consumers on Chinese imports right back into the hands of American consumers (via government spending or tax rebates), so they can continue buying more Chinese imports.

The Chinese demand for dollar denominated financial assets, including government bonds, corporate stocks and bonds, and real assets like real estate, factories, buildings and so on, has resulted in a long period of a strong dollar. If the Chinese ever decided to stem the flow of dollars into American assets, the dollar's value would plummet to record lows, leading to high inflation and eventually a balancing of America's enormous current account deficit with China and the rest of the world.

However, a falling dollar is the last thing China wants to see happen, for two reasons: One, it would make Chinese imports more expensive thus less attractive to American households, thus harming Chinese manufacturers and slowing growth in China. Two, US dollars are an asset to China. Its $1.4 billion of US debt would evaporate if the dollar took a major plunge. To China, this would represent a loss of national wealth; in effect all that 'savings' that makes China so unique would disappear as the dollar dived relative to the RMB. For these reasons, it seems likely that China will continue to be a willing buyer of America's debt, thus the financier of Americans' insanely high consumptive lifestyle.

Questions:

1. Many people in America are terrified that the Chinese might dump their dollar holdings. What would happen to the value of the US dollar if China decided to change its foreign reserves to another currency?
2. Why is it very unlikely that China will do this? In other words, how does the status quo benefit China as well as the US?
3. How do American households benefit from China's financing of the government's budget deficits? In what way to they suffer from this arrangement?
4. Do you think America can continue to finance its budget deficits through the continued sale of debt to foreigners forever? Why or why not?