CHINA US Focus Perspectives shaping the world's most important bilateral relationship

US Expert Reactions to the Global Economic Situation

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What do you see as the largest issue facing the China-US economic relationship after the US credit downgrade?

Baker: I don't think anyone takes this downgrade seriously. S&P's judgment is widely regarded as almost worthless, they made a $2 trillion accounting error and correcting it did not even affect its decision.

Levy: With evidence that the U.S. economy is slowing and the Chinese economy is overheating, the largest issue will remain rebalancing.

Ikenson: Global economic contraction is the greatest threat to the bilateral relationship. More specifically, economic contraction interpreted through the prisms of domestic politics in both countries presents the greatest threat to an otherwise satisfactorily-evolving economic relationship. With an intense election campaign season about to begin in the United States and new leadership soon taking the reins in Beijing, it is quite likely that politicians in both countries will seek to score points with domestic constituencies by scapegoating or demonizing the other country.

How do you think the credit downgrade will impact China and the global economy?

Baker: It will have basically zero effect. U.S. bond prices soared in the first trading day after the downgrade; investors do not take it seriously.

Levy: The credit downgrade is likely to focus Chinese attention on the significant downside risk to massive reserve accumulation. Hopefully, that will lend support to those within China who have been urging adjustment to a more consumption-driven economy.

Ikenson: Though I agree with S&P's move, it may prove to be the credit division's undoing. The market immediately demonstrated the practical insignificance of the credit downgrade by responding with even greater demand for U.S. debt, squeezing yields in the flight to safety and affirming that creditworthiness is a relative concept. Nonetheless, the downgrade should be a wake-up call, particularly for Americans (as big borrowers) and Chinese (as big lenders). The Chinese government has long been concerned about its exposure to U.S. inflation and dollar depreciation stemming from its limited investment diversification — specifically, its heavy dependence on U.S. debt. The downgrade may force changes in China's investment habits and choices, which might enable greater liberalization of China's capital account, and which may then open the door to a macroeconomic adjustment mechanism that facilitates global rebalancing and a return to strong, sustainable global growth.

What do you see as America's next step to improve its economic credibility with the world?

Baker: It has no need. Investors continue to flee to the dollar in a crisis, not from it.

Levy: The United States needs to put itself on a credible and sustainable fiscal path, which largely means addressing problems with entitlement spending.

Ikenson: To restore credibility and to counter suggestions that America's best days are behind it, the United States must experience sustained, moderate-to-robust economic growth once again and chart a course that leads to smaller, more efficient government that pays for its operation (and its debt) with current revenues. The plan to get America on that course eliminates redundant or otherwise unnecessary regulations, overhauls the tax code to encourage productivity and investment and to discourage dependence, reduces or eliminates all bureaucratic obstacles to wealth creation, incentivizes innovation and entrepreneurship, encourages competition in education and health care delivery, and welcomes investment, goods, and skilled workers from around the world.

What lessons do you think Chinese leaders will take from the US Congressional debate on the debt ceiling and subsequent downgrade?

Baker: They should understand, if they don't already, that they absolutely will lose money on their holders of U.S. Treasury bonds. When they want to offload them it will depress the value of the dollar, leading them to get paid back in currency that is worth less than what they lent. They may view this loss as being an acceptable price to sustain their export market in the U.S., but they must understand that they do lose money on this deal.

Levy: The lessons they likely will take revolve around the riskiness of their large debt holdings. The lessons they should take involve how a democracy can ultimately reconcile conflicting views about a country's economic direction.

Ikenson: The lessons Chinese leaders should take is that the United States is at the very early stages of recognizing that it is on an unsustainable fiscal path and that serious policy changes must be implemented. Those changes will likely include reduced government spending and possibly higher taxes, both of which could lead to reduced U.S. demand for Chinese goods. Accordingly, China should fast track its efforts to stimulate domestic demand and scale back its reliance on export-lead growth. China should recognize that the fate of its own economy is tied to that of the global economy. China should consider the benefits of liberalizing its capital account and floating its currency. China should not shy away from playing a more significant role in the global adjustment process. And China should also recognize that its policy actions during this uncertain period for the global economy will go a long way toward defining the direction and character of the bilateral relationship for years to come.

As you know, China holds a large amount of the US debt. Will China sell its treasuries as a result of the credit downgrade? Why or why not?

Baker: No, it wants to continue its policy of propping up the dollar to sustain its export market, although it probably would be best for China to move toward a more domestically oriented growth path.

Levy: China is unlikely to sell U.S. debt as a result of the S&P downgrade for the simple reason that it has few alternatives. Europe has its own serious troubles, Japan would not welcome the influx of funds, and exchanging bonds for domestic currency would spur RMB appreciation.

Ikenson: China will likely reduce its holdings of U.S. treasuries, but at a gradual pace. The Chinese government has been looking for alternatives over the years, but for reasons related to Chinese policy obstacles, as well as the relative attractiveness of U.S. debt, divestment never materialized as an attractive option. A major shift to other sovereign debt or to other non-dollar denominated debt could result in large foreign exchange losses, but remaining in Treasuries exposes China to the risks of U.S. inflation. One way to mitigate both risks is for China to buy other U.S. investments, like factories, land, hotels, buildings, and equities. Although some U.S. politicians may howl in an election year, that investment shift would be mutually beneficial.

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