CHINA 2010

中国改革
CHINA REFORM
ANNUAL EDITION

TRENDS
ECONOMY
FINANCE
SOCIETY
REGIONS
BUSINESS
WORLD
CULTURE

财新传媒
Caixin media

U.S.

CLOUDY IN AMERICA, CLEARING IN CHINA

Fiscal debt and government largesse are risking long-term U.S. economic growth, while China is counting on growth through the market.

| *By James A. Dorn | Vice President for Academic Affairs at the Cato Institute in Washington DC*

U.S. RECOVERY FROM THE GREAT RECESSION THAT OFFICIALLY ended in the third quarter 2009 has been sluggish and tainted by high unemployment. Real economic growth is expected to improve over the next two years to about 2.5 percent. But that pales in comparison with China's 8 to 9 percent growth path.

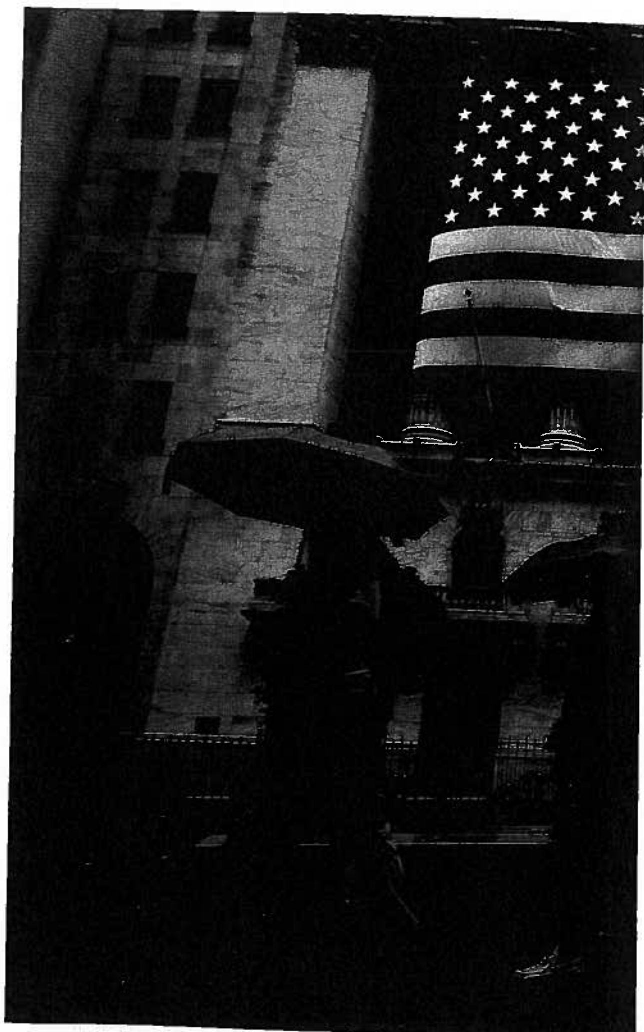
Massive U.S. fiscal and monetary stimuli did not change the fact that China rose while America struggled. The once-mighty dollar is no longer as good as gold. The federal reserve is under attack for easy monetary policies that helped fuel the credit bubble by keeping interest rates too low for too long, especially in 2003-'04 when the real federal funds rate was negative.

American taxpayers are angry about bailouts and growing public debt. The federal budget is bursting at the seams, with spending at record levels and a US$ 1.4 trillion deficit in fiscal 2009. The congressional budget office predicts government deficits will be in the trillion-dollar range for the next decade, which means the national debt will grow to about US$ 24 trillion by 2020.

If China and other foreign creditors gradually lower their exposures to U.S. debt, there will be serious repercussions for U.S. credit markets and the real economy. A plausible reaction would see the Fed continue flooding the economy with easy money during 2010, a congressional election year, while focusing on unemployment rather than monetary stability. The Fed could face political pressure to support U.S. bond prices if global demand declines. Fed action could keep long-term interest rates artificially low but would fail as investors flee the dollar.

As of late 2009, the Fed was paying interest on more than US$ 1 trillion in excess reserves. That policy kept a lid on money supply and credit growth, while the central bank increased the monetary base. As the economy begins growing in 2010, however, banks will have incentive to lend excess reserves, which will feed into money growth and increase inflationary expectations, making the dollar less stable.

The Fed's "exit strategy" calls for increasing interest rates on reserves to prevent inflation. But political constraints could prevent it from raising rates to levels high enough to stem new lending. To successfully control inflation, the Fed will ultimately have to drain reserves from the banking system and increase the



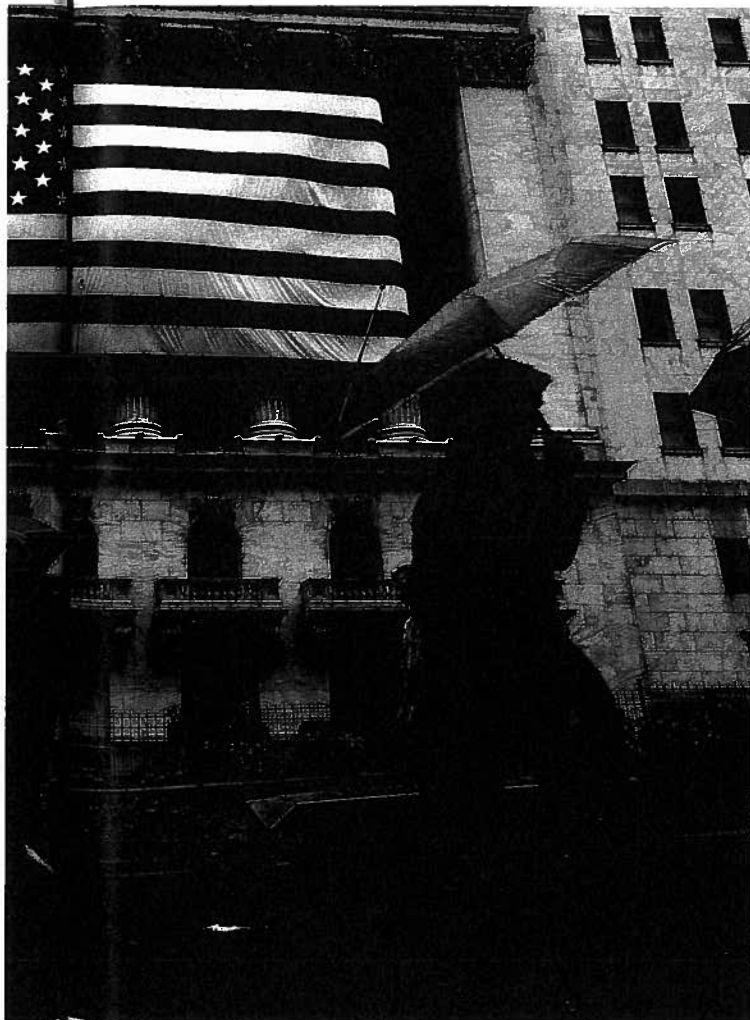
On July 21, Fed Chairman Ben Bernanke announced that the U.S. economy was showing signs of stabilization. CFP

federal funds rate.

The longer the Fed waits to take decisive action toward normalizing its balance sheet, which has expanded by nearly US$ 2 trillion since October 2008, the more costly the final adjustment. The danger is that the Fed will wait too long to apply monetary brakes, and when it does we will get stagflation and a W-shaped recovery. Indeed, there has been no concerted policy effort to curb imbalances.

All indications are that the government will continue growing and tax rates will rise. Higher government spending and taxes with more regulation will slow economic growth. As the state's "grabbing hand" interferes with economic freedom, the "invisible hand" of the market will suffer. The challenge ahead will be to find the proper balance between state and market. In the United States, that balance has always favored individual over state, and market over centralization.

Economic liberty means people should be free to choose within a legal framework that protects life, liberty and property. That's the basis of U.S. rule of law. Today, laws are made in a constitutional vacuum; the Fed has extended its power to include fiscal policy actions, such as buying toxic assets, while future generations are saddled with debt.



There is no anchor to the U.S. monetary regime, which is a pure fiat money regime. And there is no monetary rule to lend certainty to the Fed's actions. The government's dual mandate —full employment and price stability—fails to recognize the limits of monetary policy. In the long run, the Fed can only control nominal, not real, variables. But policymakers seem only to be concerned with the short run.

The political dynamic in 2010 will include fighting unemployment with easy money and profligate government spending. The emphasis will continue to be stimulating aggregate demand rather than increasing economic freedom through institutional changes that make individuals responsible for choices and allocate capital according to market prices. Keynesianism, not market liberalism, is in vogue. But even Keynes recognized the danger to freedom and "liberal" development—in the sense of expanding individual choices—that government planning can pose.

In the 1930s, Keynes sought new policy tools to encourage full employment. But he warned against too much planning. He wrote in 1936: "Individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty." Long before Keynes, China's historian Sima Qian wrote: "When all work willingly at their trade, just as water flows ceaselessly downhill day and night, things will appear unsought and people will produce them without being asked."

The United States and China in 2010 face the challenge of building financial and economic harmony through less government, not more.

The Fed cannot afford to err again by keeping the federal funds rate too low for too long. And China must avoid boom-bust cycles. Harmonious development must rely on clear rules for monetary and fiscal policies, as well as protection of the private sphere. Hong Kong's mantra of "small government, big market" is worth repeating.

China's economic reforms have produced the "variety" Keynes referred to. Trade liberalization increased efficiency and widened the range of individual choices. Now, if China is to become a world-class financial center, institutions must be strengthened to safeguard rule of law and free information flow.

For its part, the United States must return to fiscal responsibility and monetary stability. Too many dollars are chasing too few goods. But odds are in favor of more, not less, government. The Fed faces pressure to continue its easy money policy. It's highly likely that excess reserves will start being loaned out as market rates go higher, even if the Fed raises the interest it pays on reserves.

It would be far better to have a known monetary rule, such as stabilizing growth of nominal final demand to achieve long-run price stability, than to leave market participants uncertain as to what the Fed is going to do.

A rules-based approach to monetary and fiscal policies, as opposed to the current discretionary policy environment, would reduce the need for forecasting. Getting the rules right is fundamental to a prosperous society.

Standard forecasts for 2010 suggest slow U.S. economic growth and faster growth in China. But those forecasts are based on static rules. The real issue is what types of rules and institutions will emerge in the next decade. If the U.S. cannot limit government growth and return to sound money, the long-run forecast will be bleak. Meanwhile, if China moves toward a freer society and adopts genuine rule of law, its future will be bright.