The Role of China in the U.S. Debt Crisis

James A. Dorn
Towson University

James A. Dorn is a China specialist at the Cato Institute and Professor of Economics at Towson University in Maryland. This article was prepared for the Hillsdale College Free Market Forum, "Markets, Government, and the Common Good," October 4–6, 2012, in Houston.

In 2001, the U.S. gross public debt was about $6 trillion; a decade later it was $14 trillion; by the end of this year it will exceed $16 trillion. A large part of that increase was absorbed by foreign holders, especially central banks in China and Japan. With the U.S. government gross debt ratio now in excess of 100 percent of GDP, not including the trillions of dollars of unfunded liabilities in Social Security and Medicare, it is time to stop blaming China for the U.S. debt crisis.

China is the largest foreign holder of Treasury debt with a portfolio estimated at $1.2 trillion or 8.4 percent of the U.S. gross public debt of $14.3 trillion at year-end 2011 (Table 1). Total foreign ownership accounts for $4.5 trillion, while the bulk of the debt is held by U.S. government trust funds, the central bank, and domestic investors. The Social Security Trust Fund and the Federal Reserve now hold nearly $6 trillion of U.S. public debt. Of course, no matter who holds the public debt, U.S. taxpayers eventually have to fund it.

The cause of the U.S. debt crisis is overspending and an explosion in entitlements, especially Medicare and Medicaid. The stimulus programs in response to the 2008–09 financial crisis have also contributed to U.S. public debt. The Federal Reserve has vastly expanded its balance sheet and in fiscal year 2011 was the largest buyer of new U.S. Treasury debt, acquiring 77 percent (Gramm and Taylor 2012).

China has also acquired a large share of new Treasury debt issues, but recognizes that its policy of undervaluing its exchange rate to maintain export-led growth, and building up a massive stock of foreign exchange reserves now totaling $3.2 trillion, is not sustainable. It does not make sense for a capital-poor country like China to be a net exporter of capital. While one cannot blame China

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TABLE 1

OWNERSHIP OF U.S. GROSS PUBLIC DEBT

(December 2011)

	Trillions of Dollars	Percentage
Gross Public Debt	$14.3	100%
Intragovernmental and Federal Reserve Holdings	5.7	39.9
Foreign Holdings ex-China	3.2	22.4
China Holdings	1.2	8.4
Domestic Holdings	3.9	27.3

NOTE: Figures in column 3 are rounded and may not add up to 100 percent.

SOURCE: Lindeman (2011), Murse (2011), U.S Treasury (2012).

for the U.S. debt crisis, which is due to profligate government spending, one can point to an unintended consequence of China's policy of financial repression—expanding the size and scope of the U.S. government.

The following sections examine financial repression in China and its impact on the U.S. debt crisis, the rebalancing that needs to occur in China to advance the role of the market and limit the power of government, the problems with China's attempt to build a "harmonious society," and the reforms that need to occur in China and the United States to achieve lasting peace and prosperity.

Financial Repression in China

Capital markets in China are tightly controlled. Benchmark interest rates for deposits and loans are set by the government to ensure that state-owned banks have a profitable spread between low deposit rates and higher loan rates. Typically, real rates on deposits have been negative. Capital controls limit investment alternatives, and the pervasiveness of the state has prevented privatization and real capital markets from emerging. The result is a highly inefficient financial sector with investment funds directed by state-owned banks primarily to state-owned enterprises. The lack of capital freedom means the range of investment choices open to individuals is narrowly limited, thus reducing their opportunities for wealth creation.[1]

Without private competitive capital markets, China suffers from the politicization of investment decisions and thus extensive rent-seeking and corruption. Steps are being taken to liberalize interest rates, relax capital controls, and increase transparency, but political factors still dominate in a one-party system without a just rule of law.

The difficulty is that China wants to protect its dynamic export sector by undervaluing the exchange rate, but in doing so the People's Bank of China (the central bank) must buy dollars at the pegged rate with newly created renminbi (the "people's currency"), which could lead to inflation unless offset or "sterilized." Yet, if the PBOC increases the interest rate to tighten monetary policy, that maneuver attracts more capital inflows. To combat inflationary pressures, therefore, the government relies on administrative controls (credit quotas) and reserve requirements, in addition to sales of central bank bills.

Relaxing interest rates and capital controls, and letting the market determine the exchange rate, would allow China to rid itself of financial repression. The government would not have to hold excessive amounts of dollar assets (mostly in the form of U.S. Treasuries and agency debt, including Fannie Mae and Freddie Mac bonds). Domestic consumption as a share of GDP would increase as the real exchange rate appreciated and as the real return on deposits increased.[2]

For years various members of Congress, including both Democrats like Senator Charles E. Schumer of New York and Republicans like Senator Lindsey Graham of South Carolina, have attacked China for its undervalued exchange rate and tried to use the threat of protectionism to push China to allow faster appreciation of the renminbi (also known as the yuan) against the dollar. What they fail to realize is that if China had a truly market-determined exchange rate, it could go down as well as up. Moreover, a free-market rate would mean the end of interventions by the PBOC and a sharp decline in the demand for U.S. debt. Interest rates on Treasuries and agency debt would increase and Congress would have to get its fiscal house in order. It is doubtful those who blame China for U.S. ills would favor that outcome.

China is unlikely to quickly rid itself of dollar assets, but it could begin shifting out of U.S. public debt, especially if Beijing expects higher U.S. inflation. The Strategic and Economic Dialogue is a forum designed to smooth U.S.-China relations and avoid the dead end of protectionism. Both the United States and China can gain from further trade liberalization and from more open capital markets (Dorn 2008).

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[1] On the topic of financial repression and the need for creating real capital markets in China, see Dorn (2001) and Li (2001).

[2] Nicholas Lardy (2012: 80) notes that Chinese households tend to have a target rate of saving to cover expected costs of housing, education, healthcare, and retirement, which implies that if real interest rates on bank deposits increased, households would save a smaller proportion out of their higher real income and consume more. In economic jargon, the income effect would outweigh the substitution effect of higher real rates.

The liberalization process would take time and its speed would depend on the pace of political reform. If China wants to become a world-class financial center, it will have to allow the free flow of information and the development of a legal system that protects persons and property.

China's large stock of foreign exchange reserves tied up in low-yielding Treasuries has funded the U.S. government while depriving the Chinese people of private-sector investments that would increase real income and consumption. As John Greenwood, chief economist at Invesco Asia, has stated,

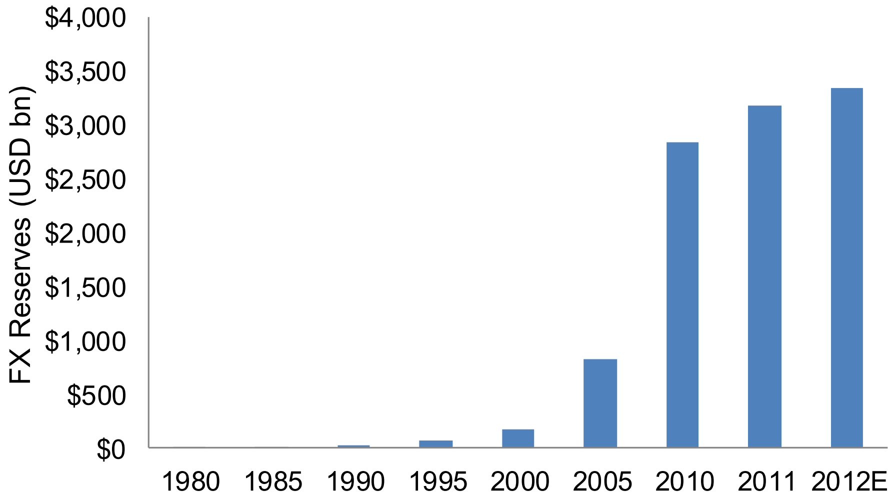
> It is undesirable and inappropriate that a country with such a low per capita income as China—a capital poor country—should be exporting capital. If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation [Greenwood 2001: 93].

Moving toward what Milton Friedman (1990: 5) called "free private markets" in China would allow individuals, not state planners, to determine the best use of scarce capital. With private owners of capital and freely determined interest rates, investors and savers could coordinate their plans and realize mutually beneficial trades, creating new wealth in the process. With more secure property rights, private capital would flow into China, creating jobs in the service sector while downsizing the bloated tradable goods industries.

Instead of accumulating low-yielding U.S. public debt and engaging in sterilization, the PBOC could focus on achieving long-run price stability by adopting a monetary rule and internationalize the renminbi. Of course, one possibility would be to have a convertible currency anchored with a commodity standard as opposed to a pure fiat money regime, while allowing markets to set interest rates. But that possibility is unlikely to be in the political choice set. China's leaders have opted for moving toward a more flexible exchange rate based on a basket of currencies.

In 1980, at the beginning of China's opening to the outside world, the foreign trade sector was small; today China is the world's largest exporter and the second largest economy, though its real per capita income is still relatively low compared to the United States, Japan, and Europe. The growth of China's foreign exchange reserves is one indicator of an upside down financial sector—that is, one driven by the plan, not the market. From a mere \$2.5 billion in 1980, reserves are expected to reach \$3.4 trillion by the end of this year (Figure 1).

FIGURE 1
CHINA'S FOREIGN EXCHANGE RESERVES
(USD Billions)



Source: UBS, *Asian Economic Monitor* (June 2012).

By using financial repression to spur export-led growth and domestic investment, China has deprived its citizens of funds that could have boosted domestic private investment and lifted consumption. Holding U.S. dollar assets in the form of Treasuries and agency debt is risky: U.S. inflation could erode the real value of those assets. The chance for future U.S. inflation may appear low at the moment, but the enormous increase in base money since the stimulus program could translate into excess money growth relative to real output if the excess reserves begin to be lent out as the economy improves. With historically low U.S. interest rates, there will be political pressure for the Federal Reserve to continue holding rates low by engaging in another round of quantitative easing. In effect, the Fed is engaging in financial repression, generating a bubble in the bond markets, and encouraging risk taking. Its manipulation of interest rates and intervention in credit markets are distorting capital markets.

The Chinese have helped keep U.S interest rates lower than they would have been by buying billions of dollars of new Treasury debt, but the imbalances that have been created cannot be sustained without tilting the balance between state and market further toward the left in both China and the United States.

The Economics and Politics of Rebalancing

China's growth model prior to 1978 was a state-led model in which there was virtually no foreign trade and the focus was on controlling the commanding heights of the economy by developing heavy industry. Justin Yifu Lin, Fang Cai, and Zhou Li (1996) have analyzed that strategy and shown how the transition from plan to market—with a switch to a "comparative advantage strategy"—has greatly benefited China and the global economy.

With the reduction of impediments to foreign trade, the end of the state's monopoly on trade, and the emergence of Special Economic Zones, the forces of the market were allowed to sweep over the coastal areas. Small fishing villages became giant manufacturing platforms. Exports and imports both grew dramatically, but official policy was to promote exports and domestic investment at the expense of consumption and services. The large trade surpluses with the United States have led to acrimony in Washington and calls for China to be labeled a "currency manipulator."

The United States has run persistent trade deficits with China, which have increased from $83 billion in 2001 to $295.5 billion in 2011, even though China is America's fastest growing export market. Of course, there is nothing inherently bad about trade deficits, which are a mirror image of financial account surpluses. However, if the capital flowing into the United States is used to buy government debt and those funds are used largely for entitlements, private investment could suffer and growth slow as government expands.

It is easy for Congress to blame China for troubles at home, rather than confront the underlying problems that plague the U.S. economy: excessive private and public debt due to overconsumption; high marginal tax rates on capital; a growing redistributive state; a low saving rate; a highly leveraged financial sector; rising health care costs; overregulation; and fiscal and monetary uncertainty because of a deviation from constitutional principles that were intended to limit the size and scope of government.

For its part, China's distorted price system, with artificially low interest rates, a pegged exchange rate, and subsidies for energy and other inputs, has protected state-owned enterprises and banks and created imbalances that could be corrected if markets were allowed to fully operate. To do so would require establishing well-defined private property rights for capital assets and land, and thus creating a legal system that safeguards individual rights.

Normalizing China's balance of payments (i.e., slowing the growth of exports relative to imports) could be achieved by a more flexible real exchange rate—obtained by letting the nominal rate adjust freely to market forces, letting inflation change relative price levels, or increasing factor productivity. China's avowed policy is to use the market mechanism to rebalance exports and imports, and use monetary policy to fight inflation. To do so, real interest rates must also be free to float. The present gap between saving and domestic investment could be closed by a higher real exchange rate, higher real interest rates, a fully convertible currency, prudent fiscal and monetary policies, and a legal system designed to increase investor confidence.

China's massive RMB4 trillion ($586 billion) stimulus package, instituted in 2008 to counter the global financial crisis, has not done much to correct key relative prices or restructure the economy toward domestic consumption. The 12th Five-Year Plan (2011–15) calls for further interest rate liberalization, gradual relaxation of capital controls, and a more flexible exchange rate. But as Lardy (2012: 152) notes, "While embracing the goal of economic rebalancing, the plan has no specifics on what policy instruments will be deployed to achieve the goal."

The coming leadership change will replace President Hu Jintao and Premier Wen Jiabao. It remains to be seen how the new mandarins will tilt the balance between plan and market. Recent decisions, however, to recognize and sanction the informal private banking sector, allow greater access to foreign capital markets, and relax controls on interest rates offer hope that China will move closer to creating real capital markets.

In March, Beijing announced the formation of a "special financial zone" in Wenzhou, a free-wheeling market city in Zhejiang. Informal ("back alley") lenders will be allowed to register as private firms and be sanctioned by the state.[3] This step will lower interest rates and increase the flow of capital going to the nonstate sector. Also, individual investors will be allowed to make direct foreign investments (except in banks) of up to $3 million (*The Economist* 2012).

Two further liberalization measures occurred in June. First, it was announced that a new economic zone in Qianhai Bay, located in Shenzhen, would be allowed to borrow renminbi directly from Hong Kong banks, thus taking another step toward capital freedom (Rabinovitch 2012). Second, in an important decision, the PBOC declared that banks would be allowed to offer loans at interest rates up to 20 percent below the benchmark rate, which is currently 6 percent for one-year loans, and pay rates on deposits up to 10 percent above the ceiling rate, which is now 3 percent on one-year time deposits. Wang Tao, chief China economist at UBS in Hong Kong, called the deposit-ceiling reform "unprecedented" and a "milestone for interest-rate liberalization" (Bloomberg 2012).

The question of rebalancing is fundamentally a question of getting prices right. No government planner can know what prices are right without free private markets. No one knows what the optimal rate of saving and investment is in China or what the right balance is between various sectors of the economy. True prices can only result from a competitive process based on open entry and private ownership. The key is adaptability and flexibility, so that adjustments take place continuously as market forces change. Getting the institutions right, therefore, matters.

Postponing institutional, and thus political reform, will slow the adjustment process while protecting special interest groups. Pressures build up when market prices are suppressed. Asset bubbles in housing and stocks form when real interest rates are kept too low for too long. China's robust growth since 1978 cannot continue indefinitely. Moving to a new growth model and away from one driven by state investment and exports will increase consumption opportunities and bring growth more in line with market forces, thus leading to a more productive use of resources.

China's leaders have promoted the idea of a new growth model and President Hu and Premier Wen have advocated creating a more "harmonious society" by spreading growth to less developed regions and decreasing income inequality (see Naughton 2007: 108–10). But they ignore the greater inequality of power that exists in China and the impact that power has on the balance between state and market. The most difficult task in

[3] On the practice of "back-alley banking," see Tsai (2002).

rebalancing will be to limit the power of the Chinese Communist Party and enlarge the range of choices open to individuals, which is the true meaning of development.[4]

Building a Harmonious Society

China's leaders have called for a "harmonious society," but their idea of harmony differs substantially from the classical liberal view of spontaneous order, in which the principle of freedom (nonintervention) brings about mutually beneficial exchanges. As Adam Smith argued in *The Wealth of Nations*, if "all systems either of preference or of restraint" were "completely taken away," a "simple system of natural liberty" would evolve "of its own accord." Each individual would be "left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or group of men," provided "he does not violate the laws of justice" (Smith [1776] 1937: 651).

More than 2,000 years before *The Wealth of Nations*, the great Chinese philosopher Lao Tzu instructed rulers in the *Tao te Ching* that when they "take no action . . . the people of themselves are transformed," and when they "engage in no activity . . . the people of themselves become prosperous" (Chan 1963: 167). During the Han dynasty, the historian Sima Qian, in his *Records of the Historian,* vividly recognized the spontaneous nature of markets, noting that "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. For clearly this accords with the Way and is in keeping with nature" (Young 1996: 138; see also Chow 2007: 13).

The spontaneous order that emerges from nonintervention (*wu wei*) rests on rules—private property, freedom of contract, and a just rule of law—that were not explicitly recognized by Lao Tzu and Taoists, as they were by Adam Smith and classical liberals.[5] Nevertheless, early Chinese thinkers understood the idea that order can emerge spontaneously from the bottom up. China's current leaders need to appreciate that insight and adopt institutions that safeguard individual and economic freedom if true harmony is to be achieved.

Conclusion

In 1988, at the Cato Institute's joint conference with Fudan University in Shanghai, Milton Friedman stated, "Peace and widely shared prosperity are the ultimate prizes of the worldwide use of voluntary cooperation as the major means of organizing economic activity" (Friedman 1990: 15). To reduce the possibility of conflict in U.S.-China relations, it is essential that both countries adhere to the principles of a liberal international order.

[4] In the tradition of Adam Smith and other classical liberals, the late development economist Peter Bauer (1957: 113) wrote: "I regard the extension of the range of choice, that is, an increase in the range of effective alternatives open to people, as the principal objective and criterion of economic development." For a summary of Bauer's work, see Dorn (2002).

[5] For an excellent discussion of the principle of spontaneous order and the importance of just rules of conduct in generating that order, see Hayek (1973, 1976).

The United States, especially in the last decade, has expanded the size and scope of the federal government, which is now spending nearly $4 trillion per year. U.S. public debt has mushroomed with no end in sight. A large part of the new debt is being monetized by the Federal Reserve, which intends to keep its target rate close to zero for another two years and possibly engage in another round of quantitative easing. There has been no concerted attempt to reduce government spending, and no progress on meaningful tax reform to simplify the system and lower marginal tax rates. It is much easier to blame China for sluggish U.S. growth then to take concrete actions to restore what Hayek (1960) has called the "constitution of liberty."

Financial repression in China, caused by major distortions in the price system (especially interest rate controls, a pegged exchange rate, capital controls, and credit quotas), has politicized investment decisions and led to imbalances. Persistent trade surpluses and capital inflows have led to massive foreign exchange reserves, a large part of which are invested in low-yielding U.S. Treasury securities and agency debt. China's consumption share of GDP is relatively low while investment and net export shares are high.

To rebalance the economy, China has announced a new growth model and top economists such as Zhou Xiaochuan at the PBOC and Yu Yongding at the Chinese Academy of Social Sciences favor a more flexible exchange rate, interest rate liberalization, and eventual convertibility of the yuan (see Lardy 2012: 147). But the pace of reform will depend on the political climate and can be expected to be slow, as witnessed by the announcement by the PBOC in February that moving toward an open capital account could take up to 15 years (Bottelier 2012).

What China needs is "market Taoism" not market socialism (Dorn 1998). It is encouraging that scholars such as Mao Yushi, who was the first Chinese economist to be awarded the Milton Friedman Prize for Advancing Liberty, in May 2012, are studying the institutional foundations for a market economy and understand the idea of spontaneous order and the importance of limited government.

The United States should adhere to its first principles and practice the ideal of liberty under the law. The 2008–09 financial crisis has resulted in a black mark for capitalism. But it is crony capitalism—not free private markets—that should be criticized.

Restoring economic freedom and personal responsibility is a challenge that United States must face, while China faces the problem of how to end financial repression and rebalance its economy by following the Tao of the market. Each country must solve its own problems—individually focusing on the issues they confront while jointly avoiding destructive protectionism. That strategy is the best path toward a peaceful and prosperous future.

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