Great Power Rivalry. China's Role as America's Creditor

"From Export Juggernaut to a Credit Addict"

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There's no doubt that China manipulates its currency to gain an unfair advantage over its competitors. There's also no doubt that Treasury Secretary Timothy Geithner will do everything in his power to avoid a confrontation with China's President Hu Jintao when he arrives in Washington in two weeks. That's why Geithner has decided to shelve Treasury's mandated currency manipulation report for the time-being and diffuse a potential imbroglio with Hu. But the Treasury Secretary's unwillingness to embarrass his guest, has angered members of congress who think the administration needs to take a tougher stand on China to protect American workers and U.S. exporters. Senators. Charles Schumer (NY-D) and Lindsey Graham (SC-R) are demanding that China be labeled a "currency manipulator" so that punitive action can be taken. That could lead a full-blown trade war with America's biggest creditor.

There's no chance that the Geithner will openly challenge Hu or that the administration will take any action that would jeopardize relations. China's President will get the red carpet treatment for the length of his visit and Geithner will spend the bulk of his time pressing the leader for concessions that will allow greater access to China's market for his buddies in the financial services industry. That's the "hidden agenda" that both the congress and the media fail to see. From Geithner's point of view, the confab is not really about "strategic dialogue" on "mutual economic and security issues". That's just a smokescreen. Geithner is backed by powerful Wall Street constituents who could care less about exchange rates or jobs. What they care about is markets and profits. And for that, they need greater access.

During his term as Treasury Secretary, Henry Paulson spent more time in Beijing than he did in Washington. But his goals were the same as Geithner's; to do whatever it takes to pry-open the biggest consumer market on earth. That basic policy hasn't changed.

No one believes that Geithner is going to fight to save American jobs. It's laughable. From his perspective, the currency flap is just stick for beating up on China when groveling doesn't work. But it's too early to put the stick to work, just yet. For now the policy is all "carrots", although that could change in an instant if Wall Street doesn't get it's way.

Americans have a fundamental misunderstanding about the US/China relationship. China is not in the driver's seat and neither is the United States. There's a third party involved, but that party remains mostly invisible. And that's how they like it. Here's an excerpt from the Washington Post which explains the whole thing:

“If the United States does decide to impose tariffs on China, Chen said, American companies operating in China, which account for more than 60 percent of China’s exports to the United States, would surely be hurt the most. ‘In the end,’ Chen said, ‘America is the one that needs to adjust.’

“While some analysts have predicted that China would soon start to let the yuan appreciate, Chen’s interview illustrated the fact that there is a strong lobby in China opposing revaluation. One reason why a revaluation would be dangerous for China, Chen said, is that profit margins for Chinese exporters are tiny — ranging from 1.7 to two percentage points.” (“China’s commerce minister: U.S. has the most to lose in a trade war” Washington Post)

To repeat: “American companies…. account for more than 60 percent of China’s exports to the United States.” That means, the head honchos of the biggest multinationals are calling the shots. China is not the villain here. After all, they’re only getting a measly 1.7 on their investment. If the renminbi strengthens at all; they’re in the red. China’s back is against the wall. What are they supposed to do; work for nothing and let the voracious multinationals walk off with 100 percent of the profits?

The truth is, China’s currency policy was probably just one of the many perks demanded by foreign corporations before they relocated to China. Naturally the CEOs would want to make sure they’d have an edge on the competition, so they (probably) persuaded Hu into gaming the system before they even broke ground. China has always gone the extra mile to accommodate the interests of the multinationals. Unfortunately, that’s the only way to entice them to relocate.

Now it looks like China is headed for a hard landing whether it tweaks the exchange rate or not. Its $600 billion fiscal stimulus and massive lending programs have inflated a credit bubble that is about to burst. Here’s a blurp from the Independent Strategy’s latest report titled, “China’s credit bubble: the missing piece in the jigsaw”:

“We now know that much of the credit explosion in 2009 that boosted economic growth went into local government entities where it was wasted on unproductive real estate and infrastructure projects. These entities are mostly insolvent and will create huge bad debts for the banks as credit is tightened this year….

Debt is big enough to be a potential source of major macro-economic instability. …This Local Government Financing Vehicles (LGFV) edifice will not survive credit tightening, because it is a Ponzi-type pyramid built upon borrowing more to service existing borrowings….the problem is economically huge. LGFVs are not going to be borrowing and spending any more. And if infrastructure investment drove 90% of 2009 GDP growth and 70-80% of this was down to insolvent LGFVs, where will the growth in credit and GDP come from now?”

The lethal combo of non-performing loans and falling real estate prices are likely to trigger a broader crisis that could spill over the borders and push the global economy back into recession. This is a real concern. Here’s an excerpt from hedge fund manager Hugh Hendry who predicts even tougher times ahead:

“The composition of China’s growth has undergone a potentially treacherous change: in the absence of expanding foreign demand for its exports, it has instead come to rely on a massive surge in domestic bank lending to fuel its growth rate. Indeed, when measured relative to the size of its economy, the 27pc point jump in bank loans to GDP is unprecedented; at no point in history has a nation ever attempted such an incredible increase in state-directed bank lending.

What a turnaround: from an export juggernaut to a credit addict. Who would have thought it necessary back in 2001, the year everything all started to work out for China?….China has become the world's biggest creditor, after amassing nearly $2.3 trillion of foreign exchange claims on us. However, the specter of a creditor nation running persistent trade surpluses has ominous historical portents. It has happened only twice before, with the US economy in the Twenties and with the Japanese economy in the Eighties. ("China: Hugh Hendry warns investors' infatuation is misguided" UK Telegraph)

China is headed for trouble. It's economy is reeling from overinvestment, underconsumption, and razor-thin profit margins. That's a tough mix in the best of times; and these aren't the best of times. When the bubble starts to unwind; defaults will increase, consumption will drop and economic activity will slow to a crawl. That will force the renminbi to rise whether the Party bosses like it or not.

China's business model is deeply flawed. The domestic market needs to expand so there's less dependence on exports. Personal consumption is the key, which means that wages and living standards will have to rise. The government needs a wealth-distribution plan–like the New Deal–to increase demand and create a thriving middle class. And that's the rub, because the class war goes on in China just as it does in United States.

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