Couple's Counseling for the US and China

China has undoubtedly benefited from the world system created and supported by the United States. Indeed, Richard Nixon's journey to China in 1972 opened the door for China's return to the international community.

Most of the next two decades were a honeymoon for Sino-American relations. On the economic front, the US not only granted China most-favored-nation trade status, but also tolerated China's mercantilist approach to international trade and finance, notably its dual-track exchange-rate regime. In the 1990's, bilateral economic ties continued to expand. American support for China's integration into the world system culminated with the country's accession to the World Trade Organization in 2001. Since then, China's exports have grown five-fold.

Of course, China's inadequate intellectual-property protection has damaged relations (a shortcoming that may be harming Chinese firms more than US firms by deterring American – and other advanced country – companies from deploying new technologies in China). And the role of China's state-owned enterprises and official Chinese support for technological "national champions" (privileged companies that almost certainly use government money carelessly) has also hurt relations.

In fact, China's approach is akin to gambling against the odds. Successful hi-tech innovations are random events that follow the law of large numbers. When left to the market, many firms and individuals try to innovate, so the overall probability of success can increase dramatically. The market allows the law of large numbers to work, whereas concentrated government support for a few favored firms undermines it

But neither of these flaws, nor the exchange rate, is at the root of today's global imbalances. Consider the exchange rate. The United Kingdom maintained a current-account surplus for the century before World War I, and the US did the same for about 80 years before 1980. But neither country, apparently, did so by manipulating its exchange rate.

Moreover, the economies that managed to narrow their external gaps with the US substantially after World War II, notably Germany, Japan, South Korea, Singapore, and Taiwan, ran current-account surpluses throughout their rapid-growth periods. This contradicts American economists' conventional wisdom that fast-growing countries should borrow today against their larger future shares in the world economy.

One possible explanation is that the relationship between GDP growth rates and a country's current-account position is not linear. Compared to countries with very slow growth rates, countries with reasonably high growth rates should borrow. But when a country's growth rate continues to increase, its saving rate would increase faster than its investment rate, so it is more likely to run a current-account surplus.

For "catch-up" countries, like China, rapid growth is often accompanied by brisk structural change that moves factors of production, especially labor, from low-productivity activities to economic sectors with much higher productivity. This adds to the surplus by increasing firms' profitability.
China's exchange-rate policy is problematic not because it promotes exports, but because it has forced the country to accumulate a huge pile of wasteful foreign reserves. The Chinese government's reluctance to allow faster exchange-rate appreciation may reflect its aversion to large, unforeseeable fluctuations, particularly given its determination to make the renminbi an international reserve currency.

While China's economy is hampered by structural difficulties, the US is not free of similar challenges. Frankly, I am always struck by US economists' reluctance to discuss the structural problems that caused the current crisis, and that hinder America's recovery. Most seem to believe that the crisis result from bad monetary policy and lax financial-sector regulation; some even blame the savings accumulated by Asian countries, especially China.

That may be true of the immediate causes of the crisis. But its eruption was far more deeply rooted in the American version of capitalism, which aims at high levels of competition, innovation, returns, and compensation. While this model has, of course, helped the US to become the world's leading economy, it has also delivered severe structural problems.

For example, to sustain high innovation, the US has maintained the most flexible labor market among mature economies. But this does not come without costs. Companies often lay off a whole department of scientists to shift to a new product, destroying not only human capital, but also human lives. Moreover, flexible labor markets imply adversarial labor relations, particularly when compared to northern European countries. These countries are less innovative than is the US, but their economies and societies may be more resilient.

Meanwhile, the jewel of American capitalism, the financial sector, caused the crisis and is underpinning the US current-account deficit. Oil exporters aside, countries running current-account surpluses, such as China, Germany, and Japan, have stronger manufacturing sectors relative to their financial sectors, while the relationship is reversed for countries running external deficits, such as the US and the United Kingdom.

Finally, America's global hegemony has proven to be a curse as well as a blessing. The US dollar accounts for 60% of world trade, and the US has the strongest military in the world, making it a safe haven for global investors. But, while large capital inflows reduce borrowing costs, they also tend to cause current-account deficits: lower costs of capital boost asset prices, with the wealth effect then prompting people to consume more than they earn.

The policies adopted or discussed by American policymakers and scholars nowadays – quantitative easing, fiscal-stimulus packages, government-deficit reduction – seek to cure only the symptoms of a deeper malaise. As a first step to recovery, the US must undertake serious financial-sector reforms. As Lenin pointed out, financial capitalism is the highest form of capitalism – that is, it is the end of capitalism.

Lenin may have gotten the underlying analysis wrong, but today we know that his conclusion may have been right for another reason: financial capitalism forces a country into unsustainable indebtedness. Unfortunately, America's financial reforms have been half-baked at best.

For three decades, "reform" was a word reserved for the Chinese side of the Sino-American relationship. The US, one hopes, will grow to like the sound of it.

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