

# The Way Forward in U.S. – China Relations

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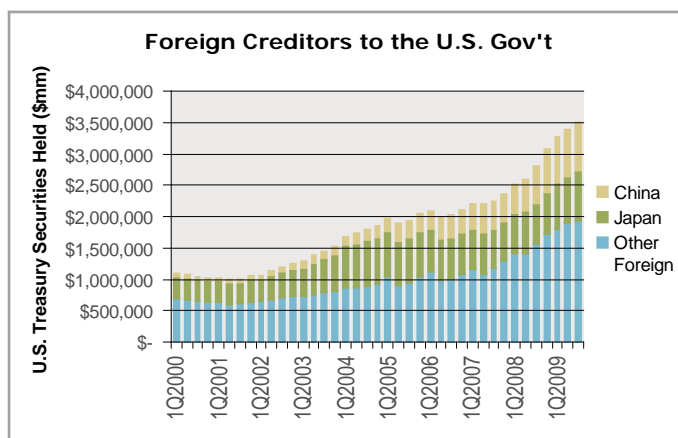
At Cutwater Asset Management, we vigilantly monitor economic and political trends and shifts to assess their potential impact on our clients' investments. But rather than react impulsively to daily market gyrations, our orientation is always toward the long-term horizon. We look beyond the clutter of day-to-day news and concentrate instead on the developments that will be truly meaningful to the economy, to markets and ultimately to our clients' portfolios.

We are currently watching the rapid rise of China as an economic powerhouse. Even beyond its importance today, China will have a continuing – and evolving – impact on world markets. It is vital, therefore, that we understand how this emerging superpower will change over time and what the implications of this change will be for the U.S. and the world at large. To that end, I have outlined in this article some of the drivers that led to the current trade imbalance between the U.S. and China, and the strategies that both countries should use, in my view, to build and strengthen their relationship going forward.

You have no doubt heard about some of the frequently discussed statistics on China's growth:

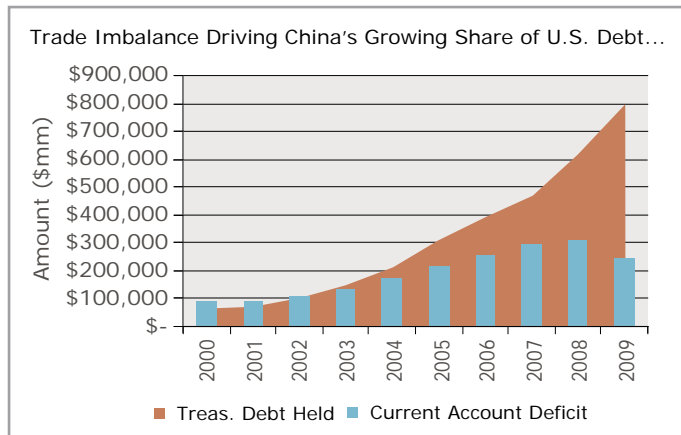
- China is now the third largest economy in the world and is expected to overtake Japan by 2011 to become the second largest behind the United States.
- If current growth trends continue, China will be the world's largest economy within a decade.
- Today, China has a middle class numbering 400 million – greater than the total U.S. population.

Equally significant is China's purchase of vast quantities of U.S. debt to support our spending habits. According to the U.S. Treasury, nearly 52% of U.S. public debt is held by foreigners, of which China's share is about one quarter of the total, and growing rapidly. Consistent with this appetite for U.S. debt, China has now eclipsed Japan as the single largest creditor-nation to the United States government, based on ownership of U.S. Treasuries.

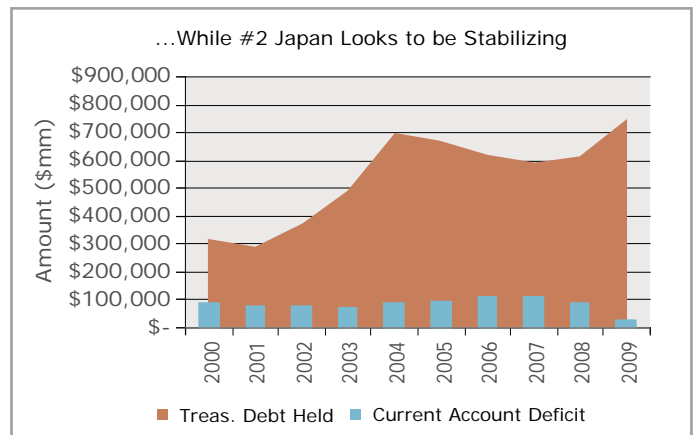


Source: U.S. Treasury

The primary driver of this situation is several years of large trade deficits between the U.S. and China. Simply put, the U.S. imports far more from the Chinese than we export to them. For instance, in 2008, the U.S. current account deficit was \$308 billion, meaning that the U.S. bought \$308 billion in goods and services, in excess of goods and services it sold to China that year. The years of trade imbalances in favor of China has accumulated to approximately \$2.2 trillion (USD) in foreign currency reserves. It is estimated that two thirds of these reserves are held in U.S. Dollar



Source: U.S. Treasury



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denominated assets of which treasuries represent \$800 billion as depicted in the above chart. Relative to Japan, the second biggest creditor, the current account deficit with China shows little sign of stabilization and evidence of China's increasing clout.

It is safe to say that without China's support of U.S. debt, our nation would be facing much higher interest rates at a time when we could ill-afford the cost. On the other hand, the more China lends the U.S., the more danger Americans run of losing sovereignty over interest rates, the value of the dollar and our overall economic health.

Clearly the rise of China as a world economic power poses risks. But there are also huge opportunities for the United States.

China is a growing economic power in the world, and how this shift in power impacts the U.S. depends on the actions, and reactions, of both countries. I firmly believe that if properly managed by both sides, China's ascent to the U.S.'s economic equal will stimulate unparalleled growth and prosperity for both nations – and for the world's economy.

One sure way to jettison this positive outcome, however, is if China and the U.S. fall into old ways of thinking about one another. If

we view our relationship as a "zero sum" (us vs. them) paradigm cloaked in mutual distrust, from both political and economic perspectives, we lose, and so does the world.

To be sure, China has its fair share of political, economic and human rights issues. And yet, since the 1989 Tiananmen Square debacle, it has marched steadily forward, opening up markets and creating better property rights while demonstrating more tolerance for freedom of speech. There is a long way to go, but China's progress toward openness has accelerated greatly in the 20 years since Tiananmen.

The United States has its share of issues too. The worst economic downturn since the Great Depression has strained our credibility in world markets and challenged our presumptions of economic superiority here at home. Arguments abound over the growing deficits, fiscal irresponsibility, the gap between the rich and poor, excessive consumerism, and the lack of integrity in our largest and most revered financial institutions. We have much work ahead of us. But I am convinced that if we accept and even embrace the continued ascent of China, some of the challenges we currently face can be overcome, to the mutual benefit of both nations.

It may seem obvious that we should avoid repeating the mistakes of the past, yet there is continual talk about restricting trade with China to slow the import of its goods and the export of American jobs. One has only to remember the Smoot-Hawley tariffs and their role in intensifying and prolonging the Great Depression to realize what a disastrous error this would be.

We also hear old, critical refrains, some directed by President Obama at China (“You, sirs, need to raise your currency rates to slow exports to the United States”), and some from China’s President Hu Jintao directed at the U.S. (“You, sirs, must get your fiscal house in order”). Such rhetoric raises the risk that what should be a beneficial relationship between two willing partners will deteriorate into a dysfunctional marriage – a “shotgun wedding” – between a spendthrift and a dowager.

If both nations don’t change the ways in which they deal with one another, a Cold War mindset may re-emerge, hurting world productivity, harming U.S. growth and causing America and China to miss out on the benefits of a unique relationship. The Chinese may come to believe their economic growth should lead to a military build-up and greater political power. The U.S. may conclude that it must exercise as much of its existing political power as possible, requiring even more military spending and leading to rising capital inefficiencies. Such a downward spiral of mutual distrust would force “guns vs. butter” choices on both nations, pulling precious capital away from innovation and toward government command and control. Recall that Russia ultimately collapsed because of its desperate attempt to keep pace with America’s military build-up.

All of this sounds foreboding, I know - yet I remain optimistic. Why? I see another way –

a new partnership approach to our dealings with China.

Start with the fact that China and the United States seem to be moving closer in economic ideologies. While China, a long standing socialist society, is shifting toward a more capitalistic model, the U.S. seems to be adding elements of socialism, especially in the wake of the banking and financial crisis. Evidence of China’s shift can be seen in the opening of its economy and markets, increasing transparency in business through stronger property rights, increasingly free political discourse and the stated desire to move away from a purely export-based economic model. A good example of this is the country’s purchase of a record 1.3 million cars from GM in 2009 – today GM holds over 13% of the automotive market share in China! While China is making significant progress towards capitalism, the US is pushing toward greater protectionism, more stringent regulation, higher taxes, adding entitlements, and generally increasing the governments participation in driving the economy.

This is not truly a role reversal, but I see in it the need for a new national conversation and the development of a partnership-based solution that harness the many opportunities our nation will enjoy with the rapid rise of an economy the size of China.

Based on such factors, I believe the primary principles to move U.S.-China relations forward are these:

- 1. Change the paradigm of how each side thinks about the other – and leave “zero sum” thinking behind.** Each party should leverage its own comparative advantages so that the economic relationship between the largest and the soon to be second largest economy in the world results in a catalyst for renewed vigor in economic activity and accelerated growth in global and

U.S. GDP. The U.S. brings intellectual innovation and highly advanced capital markets to the table, while China brings a powerful labor economy and the growing market potential of its consumers. If China lifts just 20% of its 1.3 billion people into the middle class, it will create a consumer market equivalent to the entire United States. Ultimately, this will mean abandoning the longstanding roles of buyer (U.S.) and seller (China) in favor of a more sustainable symbiotic relationship which will greatly benefit U.S. economic prosperity.

**2. End the negative political rhetoric that threatens to disturb this relationship.** The U.S.’s unrelenting focus on human rights and censorship issues fails to recognize how many positive steps have been taken since Tiananmen Square and how these changes make it impossible for China to roll back. Similarly, the U.S.’s close ties to Taiwan should become less of an issue for China as it becomes more economically and politically open.

**3. Avoid capital inefficiencies associated with military build-ups.** Political leaders of both nations should be focused on limiting this danger. Unfortunately, because both China and the U.S. have increased military spending recently, there is some concern that an arms race might develop, accompanied by the kinds of wasteful spending that charac-

terized the last one. While the U.S. did defeat the Soviet Union, the victory came at a high price, considering the investments America had to forego in areas like domestic infrastructure and technological innovation.

**4. Increase fiscal responsibility.** The charge of irresponsible behavior is most obviously leveled against the U.S. in light of the ongoing financial crisis and the deficit spending meant to tackle it, but it applies to China too. The Chinese live under the threat of runaway inflation because they lack the ability to check their super-heated economic growth, particularly in the outer provinces. The maintenance of their currency at artificially depressed exchange rates exacerbates this danger.

None of the principles I have described here are revolutionary or daunting. In fact, it is their very simplicity that makes them compelling. The blame will fall squarely on our generation if we squander one of the greatest opportunities for harnessing the benefits of “comparative advantages” to come along since Adam Smith and David Ricardo introduced the concept. By better integrating and balancing our relationship through the recognition and optimization of each nation’s strengths, the U.S. and China can collaboratively help to raise living standards around the world. ■



### ABOUT THE AUTHOR

Clifford D. (Cliff) Corso is President and CIO of Cutwater Asset Management, a fixed-income investment management firm with a distinct focus on the long view. With over 25 years in the industry, Cliff directs the investment of over \$42 billion in assets belonging to state and local governments, sovereign governments, pension funds and large institutional investors. Throughout his career, he has managed a wide array of fixed income products, including corporate, asset-backed, government, mortgage and derivative products. Cliff received his bachelor’s degree from Yale University and a master’s degree from Columbia University. He

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