



US-CHINA RELATIONS PROJECT POLICY MEMO

Improving US-China Relations: The Next Steps

POLICY RECOMMENDATIONS

- Allow China's currency to float freely—floating upwards on the exchanges
- Transfer Chinese-owned debt to equity in the US market
- Stop the Chinese practice of sterilizing incoming foreign exchange—allowing prices to rise and incomes in Chinese consumer hands to be spent.
- Reach agreement on the size, geographical distribution, and purpose of Chinese and US armed forces.

By Richard Rosecrance, director of the US-China Relations Project at the Belfer Center, Harvard Kennedy School

Both China and the United States are now emerging from the slumps of the 2008-09 “Great Recession.” But neither country has done much to address the imbalances that helped to precipitate the crisis. China has already succeeded with the stimulus of its own economy. The United States is continuing to provide stimulus and also very low interest rates. China's success, however, means greater inflation, which will have to be checked by higher interest rates. If interest rates go up (and capital remains mobile), the Renminbi must rise as well. This suggests that the recent link between the Renminbi and the US dollar must be attenuated or broken. A higher Renminbi will have two advantages: for the United States, it will help to equilibrate the past trade imbalance; for China, it will stimulate consumption (and enhance imports). It will therefore help China switch from a purely exporting strategy to one that maintains domestic growth through internal consumption. The goods that were to be sent

abroad can now be consumed by an increasingly middle class nation at home. These steps will bring China and the United States closer economically and increase international stability. However, unless the military-security relations of the two countries improve, this will not be a sufficient remedy for the two nations' long term problems.

In 2009 a group of faculty members at the Belfer Center at Harvard Kennedy School joined with the Chinese Academy of Social Sciences to produce “Power and Restraint: A Shared Vision for the US-Chinese Relationship” (NY: Public Affairs, 2009). This volume began with the premise that Great Powers too often fight, especially when the power trend of one state rises to approximate that of an established leader. Britain and Germany faced this difficulty at the end of the 19th century, and they failed to solve it. On the other hand, America's rise vis a vis Great Britain was an even more challenging event and might have led to conflict. It did not. This was because Britain made every effort to admit the United States to the great power system and to satisfy its requirements in that new role. Britain,

however, did not make similar adjustments to the rise of German power, and that failure (and the mutual failure of Germany to acknowledge Britain's concerns) led directly to the First World War. The United States and China obviously do not want to repeat the errors of Britain and Germany: what can they do about it?

One relevant historical example is relations between Britain and Germany under Otto von Bismarck, the German chancellor in the late 1800s. Under his leadership, Britain and Germany aimed to differentiate their foreign policy functions. Britain was the primary sea power; Germany a predominant land power. Bismarck did not seek a great navy, and Britain did not amass a continental-style army. When Bismarck was succeeded by Emperor Wilhelm II, however, Germany changed its policies and resolved to challenge Britain at sea as well as perhaps on land. The differentiation of function was obliterated, and the naval arms race contributed to the adverse climate of relationships that led Britain to oppose Germany in the war.

Today, China and the United States are both spending substantial amounts on armaments. There is no apparent differentiation of function: China is aiming at an increase across the board: in air, space, as well as land and naval forces. If these come close to approximating those of the United States, there is likely to be conflict between the two powers. The United States needs to understand the limits China places on these forces to relax on its own military preparations. These understandings have not yet been reached. In economics, the two powers are also proceeding on diverse tracks. The United States has become more indebted as a result of importing too much and exporting too little, with China as the main beneficiary of the US deficit. China has placed the funds it has earned in the US money market and US government securities. Meanwhile the dollar has fallen, and this has meant that Chinese investments have deteriorated in value, so much so that China has spoken recently of the need to diversify its holdings, perhaps shifting part of its funds to SDRs or to a basket of foreign currencies.

This would put further pressure on the US dollar and thus depreciate China's current holdings.

Perhaps China would like the United States to increase interest rates, but it cannot do that now, with the American economy just coming out of crisis. Another alternative would be for China to consider switching some of its debt instruments (US government bonds) for equities in the private US economy. Sovereign wealth funds are already doing this and further purchase of US equities or investment in US companies could return value to China while limiting holdings of US debt. Here China would have to be sensitive to US investors and political leaders in limiting its percentage acquisition of American firms. These changes would not undercut the value of the US dollar. Also, if China ended "sterilization" of incoming foreign exchange it could both stimulate its own domestic consumption and also make more likely an equilibrium in the trade balance with the United States. In the longer term, the Renminbi will have to fluctuate freely, or it will not be held as a reserve currency by other countries. In the medium term China cannot switch dollar holdings for SDRs. This will only create another dollar hoard in the coffers of the IMF which its management will not accept.

Most important, however, is an agreement on the size and use of Chinese and American military forces. The United States has already accommodated to British, French, and Russian intercontinental forces. If China aims to construct six SLBMs, that presents no problem. If it constructs three or four carrier battlegroups, there is no problem. But if it were to aim at 20 SLBMs or 12 carrier battlegroups, it would start an arms race with the United States that would have unknown consequences. These must be avoided.

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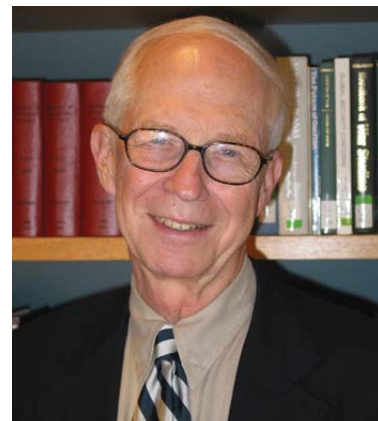
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