

Financial Interactions between China and the United States

Lawrence J. Lau, Ph. D.

President and Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

Chinese Academy of Social Sciences and Harvard University
Conference on “Building Constructive and Cooperative Sino-US Relations”
Beijing, December 15, 2007

Phone: (852) 2609-8600; Fax: (852) 2603-5230

Email: LAWRENCELAU@CUHK.EDU.HK; WebPages: [HTTP://WWW.CUHK.EDU.HK/VC](http://www.cuhk.edu.hk/vc)

A Preview

- ◆ Introduction
- ◆ Macroeconomic Complementarity
- ◆ China and the United States as Origins of Investment
- ◆ China and the United States as Destinations of Investment
- ◆ Mutual Provision of Financial Services
- ◆ What Can China and the United States Learn from Each Other's Experience?
- ◆ Concluding Remarks

Introduction

- ◆ There was little or no financial interaction between China and the United States before 1978; financial interactions began to grow gradually after the mutually frozen/nationalized assets were settled some time in the 1980s.
- ◆ Direct investment on the part of U.S. firms such as Hewlett-Packard, IBM, and AIG began in the 1980s. Direct investment on the part of Chinese firms came much later, after 2000—e.g., Lenovo acquisition of the IBM ThinkPad operation, and the failed attempt of CNOOC, Limited to purchase Unocal.
- ◆ Macroeconomic complementarity.
- ◆ China and the United States as origins of investment.
- ◆ China and the United States as destinations of investment.
- ◆ Mutual provision of financial services.
- ◆ What can China and the United States learn from each other's experience?

Macroeconomic Complementarity

- ◆ China has too much savings and the U.S. has too little.
- ◆ China and the U.S. have almost completely different comparative advantages—there is little overlap in the goods they export to the rest of the world.
- ◆ The demographics of China suggest that it should be making long-term investments in the rest of the world now to provide the necessary returns to support the pension system decades later as the relative returns to capital and labor shift to labor.

China and the United States as Origins of Investment

- ◆ China has abundant savings but not sufficient good investment opportunities. With a savings rate of between 40 and 50 percent, the marginal productivity of capital in China is close to zero, as witnessed by the excess capacity in many industries.
- ◆ China does not need any inflow of capital, especially not short-term capital. However, that does not mean it does not need foreign direct investment, which brings in technology, markets, business models, know-how, etc. But foreign direct investment can be undertaken with domestic Chinese debt without necessarily the inflow of capital provided that guarantees are available.
- ◆ The U.S. is the world leader in innovation—technology, business models and has a large market on its own. Moreover, the returns to innovation can be greatly magnified by global market expansion (fixed cost of innovation, low marginal cost of exploitation).
- ◆ China is still in the early stage of being a foreign direct investor—one has to ask: what can China offer other than money? China is probably a much better source of portfolio investment than direct investment.

China and the United States as Destinations of Investment

- ◆ Reciprocal rights and obligations. Is national treatment sufficient? National treatment is not necessarily the same as full reciprocal treatment.
- ◆ Full national treatment is unlikely on either side, e.g., ownership of communication and transportation companies and media.
- ◆ It may be useful to compile a list of industries that will be open for national treatment on both sides.

Mutual Provision of Financial Services

- ◆ Banking—significant U.S. investment in the Chinese banking sector. Reciprocity is important. These considerations apply to ownership percentages, procedures for regulation and supervision, etc. Probably independently established wholly-owned subsidiaries may be the best model. Foreign interest in the Chinese banking sector is motivated in part by the large minimum interest rate spread mandated by the People's Bank of China, the central bank, which guarantees profits to commercial banks. Inter-bank lending and borrowing as a source of funding is probably a viable alternative to retail deposit-taking for the commercial banks of both countries in each other's markets.

Mutual Provision of Financial Services

- ◆ Securities—Listing of depositary receipts of major firms in each other's market; both equity and debt fund-raising in terms of Renminbi by U.S. firms in Chinese capital markets. China is a good source of capital: high price/earning ratios in China means that the rest of the world looks cheap. Jointly owned or authorized companies to engage in arbitrage across borders. The premium and discount on depositary receipts provide an indication of the degree of excess demand for or supply of foreign portfolio investment in China, and hence a predictor of the likely consequences of a lifting of capital controls.

Mutual Provision of Financial Services

- ◆ Mutual financing of exports. There is actually no need to finance imports from the other country if both countries will finance the own exports of each to the other. Exports of durable goods can probably be financed by the respective export-import banks. However, China can well try to help finance non-durable U.S. exports to China. There may be a potential role for Chinese trading companies in promoting U.S. exports to China, especially for small and medium-sized U.S. enterprises, in the same way that Japanese trading companies promoted and financed the exports of many East Asian economies in their early stages of economic development.

What Can China and the United States Learn from Each Other's Experience?

- ◆ Maturity mismatch should be avoided in the banking sector (e.g., the U.S. Savings and Loan Association problem; borrowing short and investing long).
- ◆ Securitization of residential mortgage loans along the lines of the U.S. (Fannie Mae and Freddie Mac) will be very helpful to China, notwithstanding the bad experience of the “sub-prime mortgage loan” crisis. The problem there is not so much the securitization but that the mortgage loans to unqualified borrowers should not have been made in the first place and that the buyers of these securities were not “duly diligent” enough.

What Can China and the United States Learn from Each Other's Experience?

- ◆ Deposit insurance on retail deposits with a ceiling amount, limiting the government's potential liabilities (but it should be compulsory and the premium should depend on size of net assets and the quality of the assets as well as other factors).
- ◆ Offering credible hedges against inflation (e.g., Treasury Inflation Protected Securities (TIPS)), which in turn enable Chinese commercial banks to offer CPI-indexed deposits with positive real rates of return to retail depositors.
- ◆ The U.S. may consider using the reserve ratio more actively as an instrument of monetary policy as the People's Bank of China has been doing. For example, by lowering the reserve ratio from 8% to 7%, the liquidity of each bank will increase by 1% of the stock of (M1-M0). The same can be done for (M2-M1).

What Can China and the United States Learn from Each Other's Experience?

- ◆ Non-financial corporations in China should not be allowed to invest in the stock market (which has been the case in the U.S. since the 1929 stock market crash, and in Japan since early 2000). They should focus on their core business.
- ◆ Elimination of double-taxation of cash dividends in China (but perhaps done in a different way, e.g., by treating cash dividend payments in the same way as interest paid, as a cost of the business).
- ◆ China should try to avoid incentives structures that encourage excess risk-taking, e.g., stock options, carry, that have only upside and no downside.
- ◆ China and the U.S. should try to rationalize financial accounting standards so as to facilitate financial interactions between the two countries.

What Can China and the United States Learn from Each Other's Experience?

- ◆ The spirit of the U.S. “Inter-State Commerce” clause should be embraced by China.
- ◆ China should try to avoid the litigiousness in the U.S. markets. The U.K. provides a better model.
- ◆ Should something be done about “irrational exuberance”?
- ◆ Should universal, or whole, banking be allowed? How good are the firewalls?

Concluding Remarks

- ◆ Financial interactions between China and the U.S. should and can be “win-win.”
- ◆ Adopting common, or almost common, financial accounting standards can be most helpful in promoting fruitful interactions and reducing transactions costs.
- ◆ Financial interactions will be greatly facilitated by full convertibility of the Yuan, with or without a flexible exchange rate. Full convertibility can probably be expected within ten years.
- ◆ Short-term capital movements in both directions can and should be minimized, thus reducing potential short-term fluctuations in the exchange rate. Ultimately, financial interactions are facilitated by a stable real exchange rate.