

How Much Leverage Does China Have?

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U.S.-China talks won't accomplish much on economic issues because the Obama Administration is reluctant to push China on its purposeful manipulation of currency markets and undervaluation of the yuan.

Analysts argue, and the White House seems to agree, that the United States can't push China much on the yuan or on many other issues, because it buys so much U.S. debt. That is silly.

Each month China buys dollars with yuan printed by the People's Bank of China to keep the value of the yuan low. In turn, this creates two things—a huge trade surplus with the United States and a large addition to China's dollar holdings.

China holds more than \$2 trillion in foreign currency, mostly dollars, and has limited options for investing additional dollars. Essentially, it must hold those dollars or put them into Treasuries and other U.S. debt instruments. If it had other options, it would already be using them.

If China chooses to buy U.S. Treasuries with its monthly additions to its dollar hoard, it gets interest. If it chooses not to buy U.S. Treasuries, it will be stuck with dollars that do not pay interest and those dollars will be removed from circulation. In turn, the Federal Reserve can simply replace those dollars in circulation by buying the Treasuries that China chooses not to purchase.

In the end, China does not get the interest and the Federal Reserve does—meaning the United States does not pay interest on the debt. By statute, all the interest on those Federal Reserve purchases of additional Treasuries must be remitted back to the Treasury.

If China does not want to buy the Treasuries, so what! They can paper the walls of the Peoples Bank of China with them—it would have no effect.

Of course, China could dump those dollars on world currency markets, but the resulting adjustments in currency values would be much more damaging to China's export economy than any consequences felt here. That damage to China's export economy would cause unemployment and likely social unrest of a scope and duration the Communist Party could not tolerate.

It would be better for China to cooperate with the United States and undertake an orderly revaluation of the yuan to a level that eliminates its trade surplus over a period of three years. That would be plenty of time for everyone to adjust.

In the end, China only has the leverage President Obama gives it.

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