



China's Dollar Leverage Is an Exaggerated Threat

Joseph E. Gagnon argues that despite fears that China might dump US dollars, doing so would hurt China and could even help the US recovery.

Edited transcript, recorded February 18, 2010. © Peterson Institute for International Economics.

Steve Weisman: After years of current account surpluses, China is believed to have accumulated in excess of a trillion dollars in dollar-denominated reserves. Does that mean that China has the United States over a barrel in economic negotiations? Joseph Gagnon, senior fellow at the Peterson Institute for International Economics, says not necessarily. This is Steve Weisman at the Institute with Joe to discuss this topic. Thanks, Joe.

Joseph Gagnon: You're welcome. Glad to be here.

Steve Weisman: Joe, there's a lot of discussion in the press that China can threaten the United States by dumping dollars and creating havoc in the international marketplace. Why do you think that's an exaggerated threat?

Joseph Gagnon: I think any harm China could do to the United States is actually surprisingly small and would cause more harm to China. I think they actually are realizing that they have painted themselves into a corner here by acquiring so many dollar reserves in an attempt to hold the value of their currency down.

If they sell those reserves, they're going to defeat the purpose of holding their currency down, which is what we've been sort of pushing them to do. So it's actually kind of curious. We haven't been saying, "Don't buy our assets." What we've been saying is, "Don't hold down your currency." The way they hold down their currency is by buying our assets. So in fact what we want them to do is stop [buying our assets], in other words.

Steve Weisman: China has a few options if it wanted to move away from dollars. Indeed there is some evidence that they are diversifying their reserves. What are some of the things that they would do?

Joseph Gagnon: If they wanted to stop buying dollar assets, but they still wanted to hold their currency down, there are only two options. One is to continue buying dollar assets but try to find dollar assets that are not issued by the United States if they didn't want to buy Treasury bills anymore.

Steve Weisman: You mean the US government.

Joseph Gagnon: The US government. And that would mainly be US corporations and the Fannie Mae and Freddie Mac and mortgage-backed securities guaranteed by them. And this would be fine from the point of view of US economy.

Steve Weisman: Because?

Joseph Gagnon: Because it would lower interest rates for US borrowers and it would raise the rates that Treasury has to borrow at, but it would lower the rates that other people have to borrow at and that's what's more important for our economy. So in that sense, it would be good for the United States.

Steve Weisman: Indeed, you've argued that the Fed should be doing more of this. But the Fed hasn't taken your advice.

Joseph Gagnon: That's correct. Doing more purchases of these assets by China would help our economy in the same way that the Fed doing it has helped our economy.

There are a limited number of dollar assets that are issued outside the United States by foreign governments and foreign corporations but those are fairly scattered and limited and a lot of them are not very secure and high grade. It'll be a lot of risk for China to do that—a lot of them actually ultimately fund investments in the United States anyway, so they would come back to the United States anyway. If China put its reserves in dollar deposits in the European banks, for example, that would basically flow back to fund the European banks' holding of US assets. So it would lower interest rates in the United States, again through the same mechanism. So there's almost no way around it for the Chinese.

Now, the other main way they could go is not to buy dollar assets but to buy foreign—other foreign currency assets.

Steve Weisman: The euro I suppose would be the main one.

Joseph Gagnon: But for them to hold the value of their currency down in terms of dollars—they've been pegging their currency in terms of dollars—for them to keep doing that, using nondollar assets, is even more difficult because then you have to buy even more of those from their point of view because what you're effectively doing is you're going to be pushing down the dollar against those other currencies and the renminbi will go down with the dollar.

That will force them to buy even more of these other assets than they already are buying. And it will also upset a lot of the other countries whose assets they're buying because that will be pushing up their currencies, and that's exactly what they don't want right now. So they'll be mad at China for doing that—if the Chinese do that.

Steve Weisman: Now what about the argument that, while your analysis seems logical, there might be a danger of a run on the dollar?

Joseph Gagnon: I do think that is the right thing to worry about. I think this is really not going to be so much about interest rates as it is about the value of the dollar. If they stop buying

dollar assets, that would put downward pressure on the dollar. If they actually sold dollar assets, that could make it worse. You could have a run on the dollar—a sharp dollar depreciation.

But as I've said in Peterson Perspectives before and written about, if handled properly, that actually could be a good thing for the United States. But obviously, it can be risky—

Steve Weisman: If it were disorderly.

Joseph Gagnon: If it were disorderly, it could cause problems. But we actually have never seen a harmful, sharp, and even disorderly devaluation. It's never been harmful, unless it was caused by actual inflationary actions by the government and actual high inflation, which we don't have right now. If anything, I'm more worried about deflation in the United States than inflation.

So it could actually help us solve our deflation problem. But obviously, it can go too far and the Federal Reserve would have to respond appropriately. At some point, they might need to tighten policy. Right now, in the middle of a recession, it would be good news. But if at some point, yes, it would not be—in the middle of a booming economy, for example, it will be bad news because it would over stimulate the economy and cause inflation. But we're not there right now.

Steve Weisman: Joe, thank you very much for walking us through that.

Joseph Gagnon: You're welcome.

