From the office of Texas Workforce Commission

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Opinion/Editorial

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China Buys U.S. Assets with its Surplus Dollars
by
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CONOOC, China's national oil company, recently announced an agreement with Chesapeake Energy Corporation that would give the Chinese a 33 percent share in a new drilling project set to start soon in southwest Texas. The deal reportedly will cost CONOOC more than $2 billion and is just one of a string of purchases by the Chinese who recently have gone on an international buying spree. Long known for accumulating a surplus of U.S. dollars as it grew its manufacturing base by exporting products to the American market, our manufacturing trade deficit with China more than tripled from 2000 to 2008, as it went from $83.8 billion to $268 billion. Now, China is using that excess of dollars to purchase hard assets such as oil and gas properties in Texas.

China's relationship with the dollar is well known. The U.S. Department of the Treasury reports that China holds more than $860 billion in U.S. treasury securities and China's foreign exchange reserves are believed to contain 1.7 trillion American dollars. In fact, 65 percent of China's foreign exchange reserves are composed of greenbacks. The Chinese also have pegged their yuan to the dollar.

There is growing evidence that, as the dollar declines in value, China may be hedging its bets by reducing its exposure to the U.S. currency. To lessen its vulnerability to the risk of inflation reappearing as a major problem in the U.S., China is exchanging U.S. dollars for hard assets. It's not just the energy sector that is seeing an influx of Chinese investments – a California winery was recently purchased by Chinese investors for $6 million. And according to a *USA Today* story, many states are publicly wooing Chinese investment in various industries as a means of keeping, or creating, jobs in their states.

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To some, this may not appear to be cause for alarm. After all, an increase in the flow of foreign capital sounds like a welcome shot in the arm to an economy trying to come out of a recession. Indeed, the business press recently reported that Treasury Secretary Timothy Geithner has made it clear that America will not be following monetary policies designed to strengthen the dollar's value. Just the opposite appears to be the plan as Geithner signals his belief that a weak dollar is key to America's economic recovery.

But, recent history has taught us that accounting tricks – whether in the form of Keynesian pump-priming or securitization of sub-prime loans – cannot protect us from unsound economic fundamentals. And drawing down the value of our currency in order to achieve some short-term benefit is a risky scheme fraught with peril.

One would have thought that the U.S. would have learned its lesson that inflation does not provide a path to prosperity. President Carter tried that approach in the 1970s. A weak dollar led to a rush of acquisitions of American assets by foreign investors, a period of double digit inflation, and a stagnant economy with high unemployment. It took Federal Reserve Chairman Paul Volcker, working with the full support of President Reagan, to get inflation finally under control in the early 1980s.

Do we want a repeat of the hardships experienced in the late 1970s when inflation quickly spiraled out of control? Aren't we at risk of the dollar losing its position as the world's reserve currency? Given the fact that our budget and trade deficits are so much higher than they were during that period of high inflation, isn't there the potential of hyperinflation this time around if Ben Bernanke's Federal Reserve continues running its printing presses overtime? Thomas Hoenig, of the Federal Reserve, has called this looser monetary policy a "dangerous gamble." Bill Gross, manager of the world's largest mutual fund, said recently that the dollar could lose more than 20 percent of its value over the next few years if the Fed keeps up its current approach.

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Lest we forget, Argentina has had a history of hyperinflation in the 20th century, beginning with the Perón regime in the 1940s. This has had a particularly destructive impact on the middle class in that country. During its latest bout of hyperinflation, Argentina's devaluation of its currency and default on its debt "pushed half the population into poverty," according to *The Financial Times*. In that crises, foreign creditors hedged their bets over concerns about the declining value of the Argentine peso by buying direct ownership stakes of their assets; and in 2002, when Argentina defaulted on its public debt, foreign investment disappeared.

The best known case of the destructive effect of hyperinflation took place early last century in Germany's Weimar Republic following World War I. In less than 10 years, the value of the German mark decreased to one-trillionth of its original buying power. Germans famously carried their cash in wheelbarrows when they wanted to make a simple purchase. Foreign investors responded to inflation by the buying of hard assets. In fact, this phenomenon was so pronounced that it was given a name, "die Flucht in die Sachwerte," or "the flight to material assets." But once again, when the true extent of Germany's economic and political turmoil became clear, foreign investors pulled out.

While a weak dollar may temporarily lead to an improvement in our trade imbalance, in the long run it will hurt Main Street Americans. A declining dollar will drive up prices of essential commodities like oil while the buying power of our workers' wages declines. Increasing the cost of living is precisely what we don't want to do right now.

The only real solution to bringing back jobs and reinforcing the strength of the dollar is to focus on reforming our nation's onerous corporate tax system. A better way to tax business is with a revenue-neutral, 8 percent business consumption tax that would be applied to all goods and services coming into the U.S. All companies exporting from the U.S. would receive a tax abatement or tax credit against their business consumption tax. Immediately, this change in tax policy would result in leveling the playing field

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between us and our trading competitors. It will help bring jobs home to America, get our economy moving again, and begin rebuilding our manufacturing base. Moreover, this new economic policy will lead to a substantial reduction in our trade deficit. Known as the Hartman Plan, this policy to put Americans back to work by growing the private sector is beginning to garner bipartisan support.

If we continue to see the Chinese take flight to our material assets, we should pause before celebrating their investments. It may just signal that the Chinese, skittish over seeing their dollars decline in value and tired of financing our massive debt, have seen the handwriting on the wall – even as our political elites turn a blind eye to our continuing economic decline.

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