

The Role of Currency Realignments in Eliminating the US and China Current Account Imbalances

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The high level of current account imbalances has been a major focus of international concern for a considerable number of years. In these remarks I will suggest why public and private actions in the United States and China are now likely to cause the current account imbalances in those countries to shrink and perhaps even to disappear in the next few years. If that happens, it will eliminate the largest current account imbalances in the global economy. The United States now has a current account deficit of about \$500 billion or 3.5 percent of US GDP. China has a current account surplus of about \$300 billion or 6 percent of its GDP.

Although natural market forces should resolve such imbalances without the need for specific government policies, the government actions in both countries have actually contributed to their persistence and prevented market forces from correcting the problem. That may be about to change.

Risks to the Global Economy

The United States and China are not the only countries with large current account imbalances. South Korea has a current account surplus of 4 percent of its GDP. Taiwan's current account surplus is 8 percent of its GDP. There are large current account surpluses in Germany, Norway, Singapore and the oil producing countries. The eurozone countries other than Germany have a combined current account deficit of about two percent of their GDP. There are also large current account deficits in Britain, Canada, Turkey and South Africa.

These current account imbalances threaten the international economy in at least four distinct ways. First, they create pressures for protectionist policies in the deficit countries. Although we have avoided a major trade

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war or the type of cascading tariff increases that occurred in the 1930s, deficit countries including the United States have adopted policies to protect a variety of industries.

Second, several countries have restricted the inflow of foreign capital in order to prevent further appreciation of their currencies. Because of the selective nature of such capital controls, this leads to a distortion in the kinds of investments that are made in national economies and to a misallocation of capital among nations.

Third, large capital inflows have contributed to artificially low long-term interest rates in the United States and in the global economy more generally. Before the downturn of 2007, these low rates led investors to search for higher yields by investing in high risk assets and by using excessive leverage. The low long term interest rates also contributed to the unsustainable rise in U.S. house prices until the burst of the house price bubble in 2006.

Fourth, policies that prevent currency appreciation can lead to inflation in countries with excess demand while policies that prevent currency depreciation can lead to deflation in countries with current account deficits.

What Needs to Be Done

There is no mystery about what has to be done to shrink or eliminate current account imbalances. The basic national income accounting identity tells us that a country's current account surplus is the difference between national saving and national investment. Countries with current account surpluses can reduce those surpluses only by reducing public and private saving and/or increasing investment. Similarly, countries with current account deficits can shrink those deficits only by increasing national saving and/or reducing national investment.

That is true regardless of what happens to exchange rates. The saving-investment imbalance is fundamental and it alone determines a country's current account deficit or surplus.

But changes in the current account deficit or surplus must be accompanied

by changes in the country's real exchange rate in order to maintain domestic macroeconomic balance -- i.e., noninflationary full employment. Raising national saving means reducing the sum of private consumption and government spending. Such a reduction in spending would by itself reduce GDP and increase unemployment unless the exchange rate adjusts to increase exports or reduce imports. A reduction of consumption (or government spending) matched by an equal increase in exports would maintain the level of aggregate demand (and therefore of GDP and employment). Similarly, a reduction of consumption accompanied by an equal decline in imports would maintain GDP by shifting spending from imports to domestically produced goods and services.

For the United States, the shift to increased exports and reduced imports needed to maintain aggregate demand while raising national saving requires a decline in the value of the dollar relative to the currencies of our trading partners. The natural market forces that would cause the dollar to decline relative to our major trading partners is prevented by the Chinese policy of managing the exchange rate between the Chinese renminbi and the dollar.

For a country with a current account surplus, a rise in private consumption or in government spending designed to reduce that surplus will create inflationary pressures unless the exchange rate adjusts to reduce exports or increase imports. An increase in private or public spending matched by an equal reduction in exports or increase in imports would prevent such an inflationary increase in domestic demand. That reduction in exports or increase in imports generally requires a rise in the value of the currency to make exports less attractive to foreign buyers and imports less costly and therefore more attractive to domestic buyers.

Real and Nominal Exchange Rates

The exchange rates that matter for these adjustments are of course the real exchange rates. American goods can become more competitive relative to Chinese goods if the nominal value of the dollar falls relative to the renminbi or if the U.S. price level declines relative to the price level in China (or some combination of the two). Even if the nominal exchange rate between the dollar and the renminbi is held constant by the Chinese

government, the dollar can become more competitive relative to the renminbi if the price level in China rises relative to that in the United States.

At the current time, the real exchange rate adjustment between the dollar and the renminbi reflects both the nominal adjustment and the difference between the inflation rates in the two countries. The Chinese have allowed the nominal exchange rate between the renminbi and the dollar to rise at a five percent annual rate since they ended their exchange rate freeze in the middle of June 2010. Since the Chinese price level has been rising at about five percent over the past 12 months while the U.S. inflation rate has been only about one percent, the difference in inflation rates adds an additional four percent to the change of the real exchange rate. The combination implies that the real value of the renminbi relative to the dollar is rising at about a nine percent annual rate. This is a very rough calculation since it does not take into account the fact that the relevant price index for tradable goods and services differs from the overall consumer price index. But it shows the importance of taking the movements of domestic prices into account when assessing changes in exchange rates.

The Chinese experience also shows how the domestic inflation rate reflects government controls on the nominal exchange rate. A more rapid increase of the nominal value of the renminbi would reduce the cost of imports and, by decreasing exports and increasing imports, would put downward pressure on domestic demand. In those ways, a faster rise in the nominal exchange rate of the renminbi would reduce inflation. A faster rise of the renminbi's nominal value would therefore not translate to an equally fast rise in the real exchange rate.

Government Policies vs. Market Forces

The persistence of large current account imbalances reflects government policies that alter the savings-investment balances in both the United States and China.

The large current account deficit of the United States reflects the combination of large budget deficits (negative government saving) and very low household saving rates. Those low household saving rates are in turn a

reflection of government policies that discourage personal saving by extensive unfunded social insurance programs (Social Security pensions, health care for the aged in Medicare, nursing home care through Medicaid and unemployment insurance benefits) and that encourage high loan-to-value mortgages (by tax deductibility of interest, by subsidized government mortgage rates, and by the absence of limits to mortgage loan to value ratios of the type seen in other countries).

In contrast, China's large current account surplus reflects the world's highest saving rate at some 45 percent of GDP. Some of this high national saving is caused by the very high retained earnings of state-owned enterprises. Chinese households are also high savers because the country lacks reliable social insurance programs for retirement, health care and unemployment.

The Chinese maintain aggregate demand and growing urban employment by channeling these savings into public and private investment and by encouraging high levels of exports by preventing an appreciation of the renminbi.

The result of this combination of policies in the U.S. and China is large current account deficits in the United States and large current account surpluses in China. Similar analyses would help to explain the large current account surpluses of other east Asian countries. The oil and gas producing countries of the middle east have large current account surpluses because they are converting their stock of oil and gas into funds for future spending as well as current spending.

Attempts at International Policies to Limit Current Imbalances

Reducing these large current account imbalances has been a focus of international negotiations and of the activities of the International Monetary Fund. The United States and China have had bilateral discussions about policy changes, including changes in China's exchange rate policy. These have focused too much attention on the exchange rate rather than on China's saving and investment policies. They did not succeed in changing those policies and may have caused China to resist an exchange rate

adjustment more strongly to avoid the impression that China was forced by the U.S. to alter its policy.

The International Monetary Fund has tried in several ways to persuade China to reduce its current account surplus. China's large trade and current account surplus has been a subject of the IMF's annual article four review with the Chinese government. In 2006 the IMF launched a series of discussions focused on the five countries with the largest current account imbalances. When that failed to produce results, the IMF shifted to a policy that it labeled a "multilateral surveillance process" in which countries were supposed to collectively monitor each other's behavior. That also failed to produce any effects on the policies and current account imbalances of either China or the United States.

More recently, the action has shifted from policies explicitly directed by the IMF to policies developed by the G20 countries at their periodic meetings on the theory that, for domestic political reasons, countries might be more willing to make changes that they had designed themselves rather than policies that appeared to be imposed by the IMF. The United States government came to the November 2010 meeting of the G20 in Seoul with a proposal that would require countries to agree to limit current account surpluses to no more than 4 percent of their GDP. This policy was rejected by China and Germany and was not adopted by the G20.

Any such plan to limit current account surpluses and deficits to a specific percent of GDP cannot be an operational policy because governments do not control their current account balances in the short term or even in the medium term. Shifts in the world price of oil and food cause substantial shifts in the values of imports and exports. When that happens, these external forces cause a temporary change in domestic saving and investment. For example, a rise in import prices can cause an increase in a current account deficit by causing a reduction in domestic saving, something that happened in the United States in 2007. Large market-driven fluctuations in exchange rates of countries that do not actively manage their exchange rate can also produce large unintended fluctuations of the value of imports and exports. Spontaneous decisions of households and firms to change saving and investment will also lead to changes in imports and exports that are not due to changes in government policies.

The result of the most recent G20 summit meeting was therefore a rather vague statement that the individual G20 countries would “commit” to specific policies that would shrink current imbalances. The role of the IMF would be limited to assessing the global compatibility of these national policies and suggesting ways in which individual countries might benefit from taking into account the policy commitments of other countries.

My judgement is that such “commitments” to change domestic policies in the context of G20 negotiations are not likely to have any significant effects. The president of the United States cannot really commit to changes in policies that alter national saving since he cannot control the actions of the Congress or of the Federal Reserve.

What Happens Next?

Although international negotiations have not produced any operational commitments to shrink future current account imbalances, I believe that substantial progress will be made during the next several years in reducing the current account deficit of the United States and the current account surplus of China.

Consider first the situation in the United States. Current conditions suggest that national saving as a percentage of GDP will rise as private saving increases and government dissaving declines. Private saving has been on a rising path from less than two percent of disposable income in 2007 to nearly six percent of disposable income in 2010. The forces that caused the rise in the U.S. saving rate since 2007 could cause the saving rate to continue to rise. Those forces include reduced real wealth, increased debt ratios, and a reduced availability of credit.

More specifically, real per capita household wealth has fallen 20 percent since the end of 2007, reducing the ability of retirees to dissave and causing savers to increase saving for retirement, for home purchases and for educating their children. Although the substantial rise in the ratio of household debt to assets gives households a strong incentive to raise saving in order to deleverage their balance sheets, household debt has only declined by three percent since 2007. The reduced availability of all

forms of credit has limited the ability of households to finance spending by borrowing on credit cards, home equity loans, and high loan to value mortgages.

Although the future saving rate cannot be predicted with confidence, it is worth noting that the household saving rate in the 25 years from 1960 to 1985 averaged nine percent, ranging from a low of 7 percent to a high of 11 percent. The saving rate declined after those years because of the rise in wealth and the easing of credit conditions that are not likely to be repeated any time soon.

If the saving rate now continues to rise from today's 6 percent of after tax income to 9 percent, that would raise national saving by about two percent of GDP. That is not a prediction but current conditions and past history indicate that it is a change that might very well happen.

The fiscal deficit is now 8 percent of GDP and is projected on the basis of current policy to decline to between 5 percent and 6 percent of GDP. That would raise the national saving rate by two percent of GDP. While political forecasting is even more difficult than economic forecasting, my crystal ball indicates that budget deficits are likely to decline even more than that.

A fiscal deficit of five percent of GDP would cause the national debt to rise from the current 60 percent of GDP to a politically unacceptable 100 percent by the end of the decade, a ratio not seen since the end of World War II. To stabilize the debt at today's 60 percent of GDP -- a much higher ratio than we have experienced in recent decades -- would require reducing the deficit to three percent of GDP.

I am optimistic that that is likely to be achieved or even bettered. The recent election and public opinion polls indicate a substantial increase in public concern about the size of the deficit and the growing national debt. The crisis in Europe associated with excessive deficits has increased that concern in the United States. In the recent report of the fiscal commission appointed by President Obama, a bipartisan group of senior political figures most of whom are current members of Congress, proposed very bold policies to reduce the budget deficit in the current decade by cutting specific government outlays and by radical reductions in tax expenditures.

Although Congress recently enacted a tax bill to maintain existing tax rates for two years, this has been incorrectly characterized as a big tax cut when it actually just maintained existing tax rates for two years and rejected President Obama's earlier budget proposal to make those lower rates permanent, a saving of \$2 trillion during this decade relative to the president's initial budget plan.

So it is easy to imagine an optimistic outcome in which increased personal saving raises the national saving rate by 2 percent of GDP and budget deficits decline from 8 percent of GDP to 3 percent of GDP, producing a combined saving rise of 7 percent of GDP.

Some of that 7 percent rise in national saving would be needed to finance the rise in gross investment that is likely to occur as the economy returns to full employment. Residential construction spending is now nearly three percent of GDP below its normal level and nonresidential investment in equipment and structures is about 1.5 percent of GDP below its historic share of GDP. But even with that 4.5 percent of GDP rise in investment, the net increase of saving minus investment would still be more than 2.5 percent of GDP, enough to reduce the current account deficit to just one percent of GDP.

These assumptions about private and public saving may be too optimistic but they indicate that closing the U.S. current account deficit is potentially feasible.

The implied fall in public and private consumption would depress aggregate demand and prevent a return to full employment if it is not accompanied by a fall in the relative value of the dollar that causes a shift to increased spending on American made goods and services. An important part of that exchange rate adjustment is under way because of the rise of the real value of the renminbi. The next several years may also see a return of the euro to its previous higher level once the current eurozone crisis is resolved.

The reduction of the U.S. current account deficit implies that the current account surplus of the rest of the world must also decrease, While this need not mean a lower current account surplus in China, I believe that the

policies that the Chinese have outlined for their new five year plan are likely to have that effect. These include raising the share of household income in GDP, requiring state owned enterprises to increase their dividends, and increasing government spending on consumption services like health care, education and housing. It is important that these policies are motivated by domestic considerations as China seeks to raise the standard of living of the population more rapidly than the moderating growth rate of GDP.

If China reduces its national saving rate from the current 45 percent of GDP to 40 percent without a corresponding fall in investment, the result would be to shift China from having a current account surplus to a current account balance or even a small deficit. The lower trade surplus would reduce some of the excess demand that has been causing rising inflation in China and would offset the extra inflationary pressures that would otherwise result from raising household consumption and government spending on the provision of services.

It is not hard to imagine that a few years from now the current account imbalances of the US and China will be very much smaller than they are today or even totally gone.

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