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Living with Global Imbalances: A Contrarian View

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Three propositions have become conventional wisdom in Washington and elsewhere. Americans save too little. As a consequence, the US current account deficit is unsustainably large. A necessary step to bring the global economy into sustainable balance is a significant appreciation of the Chinese currency, which in practice has been fixed to the dollar for over a decade.

All these separate but related propositions are highly questionable. This policy brief addresses each in turn. It suggests that Americans save quite enough for future generations, that the startlingly large US current account deficit is not only sustainable but a natural feature of today's highly globalized economy, and that a revaluation of the Chinese currency, far from alleviating global imbalances, would run the risk of precipitating a financial crisis. These claims are not meant to suggest there are no problems with the current state of affairs. Rather, this brief suggests that events need to be interpreted in light of the evolution of the US and world economies in recent years and that this interpretation will put the global imbalances in a different perspective.

As a starting point, recall from GDP accounting that every country's current account position must satisfy the following equation:

$$M - X = I - S - (T - G)$$

In words, a current account deficit—the excess of a country's imports (M) of goods, services, investment earnings, and transfers

from the rest of the world over its exports (X) of these categories to the rest of the world—must equal the difference between investment (I) in the country and its national savings, where national savings is the sum of private saving (S) and public saving ($T - G$)—the excess of government revenue (T) over government expenditure (G). It follows from this accounting identity, which apart from measurement errors must always be satisfied, that a current account deficit can be reduced through some combination of reduced investment and increased private and public saving. By the same token, a current account surplus can be reduced only through an increase in investment and/or a reduction in saving.

The above equation as applied to the United States for 2004 looks like the following, where all components are entered as a percentage of GDP that year:

$$5.6 = 19.6 - 15.0 + 1.6 - 0.6$$

The final -0.6 is the measurement error in the US national accounts. The current account deficit was 5.6 percent of GDP, a level that many observers considered unsustainably large. Gross investment—including investment in housing, which accounted for about one-third of the total, and modest investment by governments—accounted for nearly 20 percent of GDP, significantly up from the recession lows of 2001–02 but low by international standards.

SAVING IN THE UNITED STATES

Private saving of 15 percent includes not just the often-cited household saving, below 2 percent of personal income, but also corporate saving. Both investment and saving include allowance for depreciation of physical assets, as is appropriate in an economy experiencing rapid technological change, since “replacement” of worn-out capital typically involves significant technological improvement, not simple replacement of old machinery. Moreover, in well-managed firms, all major new investment expenditures (as distinguished from maintenance of existing structures and equipment), even those financed from depreciation allowances, are properly evaluated as new investments, to be undertaken only if they meet the firm's target rate of return. Thus in today's world,

savings and investment should appropriately be measured in gross rather than net terms, even apart from the measurement problems associated with depreciating capital in economic terms.

However, this measurement of saving takes the national accounts as they come. They were formulated in Britain and the United States in the 1930s, at the height of the industrial age. In an information- or knowledge-based economy, one needs to take a broader view of saving. Economists define saving as income that is deferred from consumption today for the purpose of achieving higher consumption in the future. The national accounts focus on productive physical capital plus housing. A broader and more appropriate concept must add at least three components of current output: consumer durables, education, and expenditure on research and development (R&D). Purchase of consumer durables and expenditure on education are considered “consumption” in the national accounts. Yet a new refrigerator may last 25 years, and the typical automobile lasts over 10 years. Education is known to have a high rate of

Americans save quite enough for future generations. Properly measured, they save a third of US GDP.

return. Education draws significant private expenditure as well as expenditure on the public school systems and universities. These items are purchased at least in part because they augment future income and consumption and to that extent should be considered savings and investment. R&D does not enter the national accounts at all (except when performed by government, entered in G) but rather is considered an intermediate business expense. Yet, studies suggest that R&D on average has a high payoff in the future, much higher than most physical investment.

In the United States, these three categories of expenditure taken together have amounted to about 19 percent of GDP in recent years—8.6 percent for consumer durables, 7.3 percent for education, and 2.8 percent for R&D. When added to the 15 percent from the national accounts, Americans save a third of GDP, properly measured. Furthermore, Americans in general have confidence in their future (despite efforts by the George W. Bush administration to scare them into believing the public pension system, Social Security, is in deep trouble). In particular, they are confident, thanks to continuing technological change, that their grandchildren will be materially much better off than they are, just as they are materially much better off than their grandparents were. It is not surprising, then, that diverse

government measures to increase private savings over the years have shown meager success: Americans are aware that they save quite enough. (This macroeconomic discussion of course concerns national averages. It is doubtless true that many families save too little for their own interests, and if they did so, private savings might increase; but by the same token, some families save more than they will ever possibly need.)

Moreover, a given amount of saving has resulted in greater real investment in recent years as the price of capital goods has fallen, by 7 percent since 1995 for total nonresidential investment (by 21 percent relative to the GDP deflator) and by 18 percent for equipment.

From an individual’s point of view, although not from a social perspective, increases in the relative prices of houses represent effective saving, particularly with a capital market that permits mobilization of home values in retirement—for example, through reverse mortgages.

Finally, it is worth noting that the market valuations of most US companies exceed, sometimes by a factor of six or seven, the book value of tangible assets (less liabilities) in the company balance sheet—a reflection of the fact that the market sensibly values the intangible assets of the firms more highly than the tangible assets. The growth dynamic in a knowledge-based economy comes from teams of people creating new goods and services, not from the accumulation of physical capital.

The corrections to saving suggested above of course apply to all countries, not just to the United States. But their contribution to total savings is higher in the United States than in most other countries, except perhaps for a few Nordic countries.

If private saving cannot be increased, what about public saving? The United States ran substantial budget surpluses in the late 1990s. At the federal level, these became deficits with the recession of 2001–02, the stock market collapse, and the Bush tax reductions of 2001 and 2003. State and local governments normally run surpluses, thanks to contributions to pension funds for public employees, although they ran small deficits in the postrecession years 2002–03. The federal deficit came to 3.6 percent of GDP during 2004. It is projected to decline slowly in the coming years, provided government expenditure is not allowed to expand unduly and the temporary tax cuts of 2001 and 2003 are not made permanent, as President Bush has proposed. So there is at least a prospect for some decline in public dissaving, and this could be accelerated through deliberate fiscal action. As discussed below, there is good reason to reduce the federal budget deficit apart from the contribution it would make to increase national saving.

THE CURRENT ACCOUNT DEFICIT

The US current account deficit reached an extraordinary \$660 billion in 2004, up from \$531 billion in 2003 and \$474 billion in 2002. This deficit has become a dominant feature of the world economy. Many contend that it is unsustainable, that it must come down, and that if it is not brought down carefully and deliberately, it will precipitate a financial collapse of the dollar and probably a world recession. Most analysts focus, as above, on the linkages of the deficit to the US economy, and on the need to raise national savings, or alternatively (but not equivalently) on the need for a substantial depreciation of the dollar against other leading currencies.

Here, in contrast, I will focus on the perspective of the rest of the world. The counterpart of the US deficit is surpluses elsewhere. Indeed, apart from measurement error, the US current account deficit should equal the sum of current account positions in the rest of the world. (In fact, there is measurement error such that the sum of the world's deficits exceeds the sum of the world's surpluses, with the difference amounting to over \$100 billion, 1 to 2 percent of world trade.) It will not be possible to reduce the US deficit without reducing surpluses, or increasing deficits, elsewhere in the world. Many countries are currently running surpluses, although some others—Australia, Britain, New Zealand, and Spain among the rich countries—run significant deficits like the United States. Rich countries with the largest surpluses are Japan, Germany, Switzerland, Netherlands, Sweden, and Singapore plus Russia, China, and the members of the Organization of Petroleum-Exporting Countries (OPEC), thanks to high oil prices during 2004. The surpluses of Japan and Germany alone equaled nearly half the US deficit and exceeded half if Switzerland and the Netherlands, two economies closely linked to Germany, are included. I presume OPEC surpluses will decline sharply over the next few years as a result of some combination of lower oil prices and higher OPEC imports.

Germany and Japan are rapidly aging, high-saving societies with limited domestic investment. Personal saving rates have declined in Japan, but saving in the corporate sector remains high. What has fallen in Japan is investment, which remains low even after a revival in 2004.

A big absorber of capital in rich countries is the residential sector. Investing in housing does not look attractive in rapidly aging societies, with low birth rates and low new household formation. If anything, Germany and Japan have a surplus of housing in the aggregate, although it may not all be in quite the right places. Housing construction is down essentially to replacement plus a little to allow for mobility. Meanwhile, rates of return on industrial investment are low and, of course,

sensitive to what is happening in the export and import-competing sectors.

For reasons having to do with their defeat in World War II, a key question for Germans and Japanese was how to rebuild their national self-esteem. Both countries built it on export performance, and the technological achievements reflected in export performance. That legacy continues five decades later. Export performance heavily influences the national psyche in both Germany and Japan. If exports are not doing well, people feel badly about the economy and society. That in turn influences their saving behavior. If the economy is not performing well, precautionary saving rises in these now rich countries.

Given the aging of their society, Japanese saving should decline and eventually become negative. That may be so, but it has been a much slower process than advocates of the life cycle hypothesis forecast 20 years ago. Saving remains remarkably high in both countries given their demographic structure.

The startlingly large US current account deficit is not only sustainable but a natural feature of today's highly globalized economy.

This syndrome, in which German and Japanese saving is sensitive to perceived economic performance, which in turn is sensitive to export performance, is important when it comes to correcting the US current account deficit. If the dollar declines significantly, as many analysts suggest it must, leading to significant declines in the export competitiveness of key surplus countries, we are likely to see an increase, not a reduction, in the propensity to save in those countries, as well as a decline in investment. Whether an increase in the propensity to save gets translated into actual additional savings depends, of course, on what happens to output and income. The conditions just described are those under which a recession in economic activity could occur. An increase in the propensity to save with no obvious vehicle for that savings leads to a fall in output and income. US exports to those countries may fall instead of rising.

In textbooks, the adjustment mechanism in this process is the interest rate, which is assumed to reconcile ex ante differences in saving and investment. But real long-term interest rates have been low in Japan and Germany for several years. Given their demographics, what sort of investment will be stimulated by lower interest rates in the presence or even with the prospect of a significantly stronger yen and euro? The sector most

responsive to interest rates in rich economies generally is the housing sector, not industrial investment. Firms will not invest in increased productive capacity if they see poor sales prospects, no matter how low the interest rate. Yet for the demographic reasons already noted, demand for housing will also be limited, even at low long-term interest rates.

Hence I do not see interest rates as being an effective adjuster here. With a large appreciation of these surplus countries' currencies, the adjuster is more likely to be economic activity. It will decline, except insofar as the authorities become so concerned about it that the Europeans break all the rules they have imposed on themselves, through the Stability Pact's constraints on fiscal policy and the European Central Bank's primary focus on price stability, and pursue an aggressive stimulative policy.

Thus, there are serious obstacles to significant adjustment in current account imbalances in both Europe and Japan. Both already have large budget deficits: Japan's deficit is roughly 7 percent of GDP, and France, Germany, and Italy, the core of the European economy, have fiscal deficits exceeding the 3 percent limit under the Stability Pact.

A large US current account deficit could continue for a long time, so long as the American economy is producing attractive financial assets.

Excess saving in these big rich countries manifests itself in budget deficits and current account surpluses. Savers directly or indirectly buy claims on their governments or on foreigners. Further reductions in the long-term interest rate are not likely to produce enough domestic investment to substitute for those two channels, particularly in the face of a decline in competitiveness brought about through large appreciations of their currencies.

Japan and Germany are perhaps unusual because of their peculiar histories, with their real and psychological dependence on export performance. But it is entirely unclear how currency appreciations will produce the large changes in saving and investment required to eliminate, or even greatly reduce, the current account surpluses of rich Asia and Europe. They may even produce the opposite effect.

Much of the excess saving in the rest of the world comes to the United States; it exceeds investment abroad by Americans and accounts for the large current account deficit of the United States. Why does this saving come to the United States rather than going to emerging markets, where returns should be

expected to be higher? The answer is complex. Some of it of course does go to emerging markets, but those countries at present, as a group, also have excess saving. Since the financial crises of the 1990s, risk-averse investors, especially in Japan and Europe, have been reluctant to invest significantly in emerging markets outside central Europe, which has largely joined the European Union, plus China. Returns in emerging markets are not only volatile but on the basis of recent experience in Russia and Argentina, may be insecure from political or legal action as well. Also, some emerging markets, notably China, have high domestic saving rates themselves, more than enough to cover their requirements for domestic investment.

The United States in contrast has investment opportunities that produce higher yields than Japan and Europe and that are less volatile and more secure than investments in many emerging markets. Moreover, the US economy is large, accounting for a quarter to a third of the world economy (depending on the exchange rate used for adding up GDPs in national currencies around the world), and has especially well-developed financial markets, accounting for half of the world's marketable securities. It is not surprising, then, that funds from all around the world are invested in the United States, as well as in Australia, Britain, and Canada, which while much smaller than the United States share some of its other desirable characteristics and are also destinations for much foreign capital.

Gross world savings outside the United States runs around \$8 trillion, rising from year to year. In a world with increasingly globalized financial markets, it would not be surprising for savers to desire to place 10 or even 15 percent of their savings into the United States, given the characteristics noted above. (Allowance for depreciation no doubt creates a home bias, but as noted above, well-managed firms evaluate all significant investment proposals afresh, even those to be financed from depreciation allowances.) Yet 10 percent of this saving would amount to \$800 billion, exceeding the US current account deficit in 2004. Indeed, in that year, an estimated \$1.1 trillion of foreign private capital came into the United States. Of course, Americans also invest abroad, and any inflows must cover those outflows as well. Still, these numbers suggest that a large US current account deficit could continue for a long time, so long as the American economy is producing attractive financial assets.

When private foreign investment slackens, as it did after 2001, foreign official investment often takes up the slack. There has been a huge build-up of foreign exchange reserves in 2003–04, especially in East Asia but also elsewhere, such as India and Russia, as a by-product of macroeconomic and exchange rate policies in those countries. Budget deficits have reached practical limits in Japan and at least in principle are constrained by the Stability Pact in Germany (and France and Italy). China

has been overheated and requires some fiscal tightening, despite large infrastructure needs. That would tend to increase China's already high saving rate, not reduce it. Private savers in Japan are highly risk averse. The Bank of Japan (acting on behalf of the Ministry of Finance) is in effect providing foreign exchange cover for private-sector savings, which from households continue to go heavily into the low-yield postal savings system. Japan's overseas investments can produce a real return to the Japanese in the future that increased Japanese budget deficits will not. Japan's reserves are now so large that it should consider separating some of them into an investment account, as Singapore, Norway, and several OPEC members have done, to be invested abroad in less liquid but higher-yield securities. In China, residents cannot legally invest abroad without specific authorization. Again, official investment abroad by the People's Bank of China occurs when private investment cannot take place. But the latent demand among China's newly well-to-do citizens for overseas investment, especially in the United States, is undoubtedly high.

These are consequences of financial globalization. Capital inflows into the US economy are said to be "financing" the US current account deficit. That is true only in an accounting sense. The motivation, certainly for private flows, more controversially for official flows, is investment in the United States. Americans have accommodated this excess saving abroad by importing much more than they export—"living beyond their means." Although eventually the savings of Japan and Europe will probably fall, as those societies increasingly age, the current configuration can endure for many years.

These flows are mutually beneficial so long as the United States generates productive assets for sale to foreigners, in financial forms that yield less than the underlying investment yields. The US economy intermediates between foreign financial investment and US real investment, properly measured. The problem at present is that the United States is producing high-quality financial claims in abundance, in the form of US Treasury securities, that are attractive to foreign institutions but that do not support an increase in the productive assets of the United States—apart perhaps from federally financed R&D. They thus represent a claim on the unaugmented future income of Americans. If the United States wants to reduce these claims, increase national saving, and encourage greater private investment, it needs to take serious steps—more serious than simply proposing cuts in expenditure programs with strong congressional and public support—to reduce the federal budget deficit.

The current account deficit represents net foreign purchases of assets in the United States. While the deficit may be sustainable from the perspective of the rest of the world,

according to the reasoning above, is it sustainable in the United States, or will foreigners eventually end up owning all the assets in the United States?

Play the following thought experiment: The US current account deficit continues indefinitely at \$600 billion, while the US economy grows indefinitely at 5 percent in nominal terms. On official data at the end of 2003, foreigners had total claims on the US economy of \$2.4 trillion, net of American claims on the rest of the world. Given this initial condition, what are the implications over time of our two assumptions? The ratio of net foreign claims to US GDP—a ratio many economists look at in assessing sustainability—will rise for some years, but it reaches a peak of 50 percent in 15 years (up from 22 percent in 2003), and then will fall indefinitely thereafter.

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Foreigners will then own more of the US capital stock—around a fifth, net of US claims abroad, if all the ownership were direct. But the United States has several layers of financial assets above the capital stock, financial assets that foreigners typically buy—by now over three times the capital stock and still growing—so foreigners would own under 10 percent of US financial assets. The yield on these assets would represent claims on US output, reducing the income of Americans relative to what it would be if Americans owned all the assets, but almost certainly leaving American incomes higher than they would have been had the rest of the world made fewer investments in the US economy, since the US capital stock would be lower.

The current account deficit, while by assumption constant in dollar terms, will fall steadily as a share of constantly growing GDP, reaching 2.5 percent in 2019, the year in which the foreign claims to GDP ratio reaches its peak, and falling further thereafter. Foreign earnings on their US investments would grow over time, so the trade balance must improve in order to maintain a constant current account deficit. This scenario may not come to pass, but it does not look unsustainable.

The test is somewhat more severe if the ratio of the current account deficit to GDP remains constant at, say, 5 percent, but that scenario also does not explode into unsustainability.

However, the deficit cannot of course continue to grow indefinitely as a *share* of GDP. Careful analysts correctly point to the unsustainability of the trajectory of the deficit that they have observed in the recent past and that they project into the

future. While the deficit can continue to rise as a percentage of GDP for a while, sooner or later that rise must halt. That valid proposition is an altogether different claim from one that the deficit, even a large deficit, is unsustainable.

A constant or constant share deficit may require some depreciation of the dollar. Foreign earnings on their growing US claims will also grow, and the trade deficit may have to decline to accommodate this (the extent depends on the yield on net foreign claims). The depreciation, in turn, will slow the growth of net foreign claims on the United States, not only by reducing the trade deficit but also by increasing the dollar value of US claims on foreigners, the so-called valuation effect, arising from the fact that most US claims on foreigners are denominated in foreign currency, whereas most foreign claims on the United States are denominated in US dollars. Thus in 2003, a year of dollar depreciation against the euro and the yen, the negative net foreign asset position of the United States *declined* by \$80 billion despite a current account deficit over \$500 billion.

In time, national savings will decline in aging societies such as Japan and Europe. And their institutional investors will regain confidence in emerging markets. Thus we can expect some decline in the surpluses of the rest of the world. But that process will take some years.

In summary, a large current account deficit for the United States is likely to continue for some years, a natural consequence of excess saving in the rest of the world, an attractive menu of financial assets from which to choose in the United States, and increasing globalization of financial markets. The United States has a revealed comparative advantage in producing highly attractive financial claims, to the mutual benefit of foreigners and Americans alike so long as Americans invest the proceeds productively. This is not to argue that there will be no financial crisis focused on sharp depreciation of the dollar, as some analysts fear, but it is to argue that such a crisis is far from inevitable and indeed that it will not arise from a large deficit per se. In particular, it would be a mistake to try to eliminate the current account deficit in the near future or even to try to reduce it to \$200 billion to \$300 billion, as some analysts have proposed.

CHINA AND THE RENMINBI

China has experienced an enormous increase in foreign exchange reserves during the past several years, reaching \$711 billion in mid-2005, second only after Japan. In 2004, \$200 billion was added, and another \$100 billion was added in the first half of 2005. The rise in reserves has occurred as a direct consequence of China's exchange rate policy of holding the value of the renminbi, the Chinese currency, at 8.28 renminbi

per US dollar. China has run a modest trade surplus since 1990 (except for 1993), which reached a peak of \$44 billion in 1998, registering \$33 billion for 2004. It has recently risen, however, and will probably exceed its previous peak in 2005. China runs a deficit in services and earnings on foreign investment. However, foreign direct investment (FDI) inflows have been substantial. The trade surplus and FDI inflows as sources of foreign exchange have been augmented since 2003 by a large inflow of Chinese resident funds from abroad, called remittances and recorded in the current account surplus, but really a return of capital that was exported some years ago. And the errors and omissions in China's balance of payments accounts, historically negative, turned strongly positive in 2003 and 2004, suggesting a further unrecorded inflow of funds. The increased remittances and other funds might have been drawn back to China by the boom conditions since 2003, particularly in real estate. They may also have been attracted, however, by increasing discussion, emanating mainly from the United States and leading to official US pressure on China, for a revaluation of the renminbi against the dollar.

The trade surplus jumped in early 2005. This was due partly to a slowdown in the rapid growth of imports, perhaps as the economy responded to the restrictive conditions the Chinese government introduced in 2004 to cool the boom and partly to a sharp growth in exports of apparel, following the expiration in January 2005 of the 30-year-old Multi-Fiber Agreement (MFA). But continued export growth occurred in many sectors, not just apparel.

Here, however, we need to avoid the fallacy of concreteness. It is true that China's exports of apparel jumped sharply, but it would be wrong to conclude that without this increase, US imports would not have increased and that remaining US apparel producers would not have felt acute competitive pressure from imports. The expiration of the MFA was agreed a decade ago as part of the Uruguay Round, with the consequential removal of quantitative limits on apparel imports from many developing countries. If imports from China had not increased, imports from other countries would have increased even more. To argue otherwise would imply that the MFA did not restrict imports from any country except China, which is implausible. Steps have recently been taken, both by the United States and the European Union, to restrain the growth of apparel imports from China—restrictions that under the rules attached to China's accession to the WTO can last until 2008.

China's foreign trade has an unusual structure, reflecting its growing role as a manufacturing processing center. Its exports of finished goods go mainly to the United States and Europe, and increasingly to Japan, and it runs large trade surpluses with both Europe and the United States. It imports materials and

components from many countries, especially Japan, South Korea, and Southeast Asian countries, and it runs trade deficits with those countries and with producers of raw materials such as Australia. Thus its overall trade surplus is considerably smaller than its surpluses with Europe and the United States; their imports from China include content from many other countries, and the domestic value-added in exports from China is unusually low. Moreover, over half of China's exports originate in firms that are foreign owned or in joint ventures with foreign partners, so earnings of those firms accrue in large part to foreigners.

The Chinese economy is engaged in a deeper process than simply becoming the world's manufacturer and assembler of low-skill labor-intensive goods. It is moving people out of agriculture, which still employs half the labor force, into more productive economic activities, in manufacturing, services, and construction. At the core, this is what development and the reduction of poverty in poor countries is all about: moving people out of agriculture into more productive economic activities. China's agricultural workers dropped from over 70 to 50 percent of the labor force over the past 25 years. Labor is being shed not only by agriculture but also, since the late 1990s, by the historically overstaffed state-owned enterprises (SOEs).

These desirable developments have no doubt been facilitated—indeed, even made possible—by strong export performance over the past quarter century and by hospitality to FDI that some other poor countries, most notably India, have lacked. But it would be wrong to label China's policy “mercantilist.” This label implies not only export promotion but also hostility to imports. Yet China's imports, like China's exports, have grown enormously—from under \$10 billion in 1979 to over \$560 billion in 2004—partly as the content of growing exports, noted above, but also for domestic consumption and investment. China's ratio of imports to GDP in 2004 reached 34 percent, much higher than that of the United States and the European Union (excluding intra-European trade), not to mention Japan, Brazil, or India.

China's economic performance over the past two decades has been nothing less than spectacular, with a drop in poverty, per China's official definition, from 250 million persons in 1978 to 22 million in 2000. This is the core of economic development in poor countries: moving people from near destitution to a condition where they have real choices.

China's development benefits not only Chinese but also the rest of the world. Increased production in China makes available many labor-intensive goods, such as clothing and toys, more cheaply than would otherwise be available, thus improving living standards elsewhere, particularly of those who are relatively poor since Chinese products so far have concentrated in the low

end of the market in many categories, including such “hi-tech” products as television sets and DVD players. China's growing prosperity also creates new demand for production in the rest of world; as we have seen, China's imports grew by more than half a trillion dollars since 1980, compared with a total growth of imports into the United States, a much richer country, of \$1 trillion over the same period. Thus, China has contributed significantly to the growth in world trade and to the productive division of labor that growing trade both reflects and makes possible.

It is difficult to see who is hurt by this process, except perhaps those in direct competition with China for the provision of low-skill, labor-intensive goods. It could include persons in other poor countries that were actually taking advantage of the production and trading possibilities (many were not), and some US apparel workers, although as noted above, if increased apparel imports from China are restricted, they will almost certainly come from somewhere else.

Two arguments have been advanced for revaluation of the renminbi. First, it will reduce global imbalances. Second, it will help dampen the overheated Chinese economy.

A revaluation of the Chinese currency, far from alleviating global imbalances, would run the risk of precipitating a financial crisis.

The issue of global imbalances has been addressed above, where it is argued that they have been interpreted incorrectly and therefore pose a less acute problem than some analysts have argued. Even if China revalued the renminbi enough to eliminate its current account surplus altogether, and if all that change (implausibly) accrued to the United States, it would reduce the US current account deficit by only 10 percent. While China's overall surplus is significant, it is small relative to the US deficit. In practice, elimination of China's surplus would not all accrue to the United States. For the reasons elaborated above, it would accrue significantly to other countries, and indeed none of it might accrue to the United States.

Some advocates of renminbi revaluation acknowledge the small contribution of the reduction of China's surplus to the reduction of the US deficit, but they go on to point out that it would permit other, mainly east Asian, countries to appreciate their currencies as well, thus enlarging the potential impact on the US deficit. But which countries exactly would welcome an appreciation of their currencies, even contingent on a revaluation of the renminbi? Apart from Japan, discussed

above, the Asian economies with relatively large current account surpluses are Singapore, South Korea, Hong Kong, Taiwan, and Malaysia, in order of magnitude. Other countries, such as Indonesia, Philippines, and Thailand, all have such small surpluses, sometimes combined with trade deficits, that it is difficult to imagine their enthusiasm for currency appreciation. They could of course move into current account deficit, but the memories of the Asian financial crises of 1997–98 are still fresh enough to counsel caution in this regard, and they would welcome the improvement in relative competitiveness for some of their industries that a renminbi revaluation would bring.

The Korean won has already appreciated by 15 percent in the past year, enough to worry many Koreans about their export performance and their economy. Hong Kong, the Philippines, and Thailand run deficits in their merchandise trade. The demographic developments in Hong Kong, South Korea, Singapore, and Taiwan are similar to those in Japan, lagged somewhat, leading them to run current account surpluses for the sake of themselves in old age and of future generations. This leaves only Malaysia and possibly Singapore (with its huge surplus) with large enough trade and current account surplus to be comfortable in following China in a currency appreciation. Their current account surpluses together were running around \$45 billion in early 2005, a modest contribution to reducing the US deficit even if all or most of it accrued to the United States.

If China's surplus were offset by private Chinese investment, there would be fewer complaints about it and fewer pressures to revalue the renminbi.

With regard to the second reason for renminbi appreciation, contributing to a dampening of the overheated economy, several comments can be made. In the eyes of Chinese authorities, the overheating is sector-specific and, in particular, concentrated in construction and the industries supporting construction, such as steel, cement, and aluminum. The real estate market has been “frothy,” to borrow a US term, especially in Shanghai and several other large cities, with signs of speculation in new residences. The government has used various instruments, both general and selective, to dampen the boom, including central bank “guidance” to the commercial banks regarding loans to the selected sectors, selective credit controls, increases in lending rates, and increased taxes on real estate turnover, plus the automatic fiscal restraint brought about by a rapid increase in tax revenues. The measures collectively have had an impact,

and indeed real estate prices in Shanghai, Guangzhou, and some other cities have not only stopped rising but have fallen somewhat. Overall inflation has dropped from its high of over 5 percent in mid-2004 to below 2 percent in the second quarter of 2005.

The dilemma faced by Chinese authorities is that they want to cool an overheated economy, and reverse the rise in inflation, without generating even more distress in the urban labor market, with its potential for political unrest, than is already occurring with continuing layoffs from SOEs. Since construction is a major employer of unskilled labor, the authorities want to reduce overbuilding without a significant reduction in building!

It is difficult to see what significant contribution a revaluation of the renminbi would make to these objectives. The main impact would be on foreign trade, especially the export sector. A small revaluation—and all deliberate revaluations in the past 50 years have been small, rarely exceeding 10 percent—would be unlikely to have a major economic impact. Rather, it might have the perverse effect of stimulating greater speculative capital inflow into China, and its neighbors, once the Chinese government accepted the principle of revaluation but at an amount deemed too low by the “market.” A large revaluation, say 25 percent, might satisfy market expectations but could do serious damage to the development process that China has cultivated so successfully, slowing significantly both growth and the reduction of poverty. Furthermore, it would undoubtedly stimulate large speculative inflows into many other Asian countries, at a minimum greatly complicating macroeconomic management of those economies, as we saw in precrisis Mexico in 1992–93 and in Thailand in 1995–96, and perhaps precipitating financial crises in those countries as the funds were withdrawn.

Renminbi revaluation is thus a high-risk strategy, with very limited gains.

Of course, if China's trade surplus continues to grow, as it has done so far in 2005, these arguments would need to be reviewed. But historically, import growth has kept pace with export growth, and as noted below, China's authorities could relax further their current restraints on imports. Thus, the Chinese authorities are not obviously wrong to wait awhile before significantly revaluing the renminbi.

All of this discussion is predicated on an assumption that the renminbi is “undervalued,” and that a revaluation is in order, even though it entails certain risks. But what exactly does it mean to say that a currency is “undervalued?” This brief is not the place for a lengthy discussion of this complicated topic. The main evidence supporting the claim is that the People's Bank of China (PBC), China's central bank, has been intervening heavily

and one-sidedly for several years in the foreign exchange market (indeed, in practice the PBC has made the foreign exchange market) and has built up large foreign exchange reserves, which are invested heavily in dollar-dominated securities. But it should be remembered that China maintains controls on capital flows into and especially out of China. Chinese citizens are not free to invest abroad as Americans or the citizens of all other rich countries are; and Chinese firms require case-by-case permission to invest abroad.

China is a country with unusually high saving rates and unusually limited opportunities for financial investment. Most savings are channeled into the banking system and a limited amount into government bonds, both at low interest rates of 2 to 3 percent. If the Chinese were permitted to invest abroad, there is little doubt that many of them would do so, particularly after the institutional developments required to make such investment easy, such as the formation of mutual funds of foreign securities and brokerage houses to sell them.

We do not complain of Germany's large current account surplus, because it is offset by private German investment abroad—heavily in central and southern Europe but more generally around the world, including in the United States. If China's smaller surplus were offset by private Chinese investment, there would be fewer complaints about it too, and fewer pressures to revalue the renminbi. Indeed, it is conceivable that if the renminbi were a floating currency, and the capital controls were removed, the renminbi would depreciate under the pressure of capital exports rather than appreciate. This possibility should warn us against casual use of terms like “undervaluation.”

There are good reasons China does not remove its capital controls and move to a fully convertible currency quickly. China's domestic financial system is still in an early stage of development, relying (as most poor countries do) excessively on its banking system for financial intermediation; and its banking system is in a fragile state due to undercapitalization and too many nonperforming loans, the result of poor lending practices. These weaknesses are being corrected, but the changes required, including institution building and development of a more commercial culture among the employees of the financial system, will take time. Opening too rapidly to foreign investment could lead to a significant withdrawal of deposits from the banking system and precipitate a banking crisis, which would not be good for China's development.

One way of interpreting the PBC's behavior is that it is undertaking the foreign investments that residents are not allowed to undertake, in anticipation of the day when controls on capital outflows will be removed and the Chinese will invest extensively abroad. In other words, the PBC is playing the role of

financial intermediary in a globalized world financial economy on behalf of China's citizens. The ratio of foreign assets to domestic credit in China's financial system at the end of 2004, including the PBC, was one to four, which is not wildly out of line in a global financial market.

The level of reserves is now much higher than that required on prudential grounds, even on a conservative interpretation of prudence. Thus the Chinese government might consider—as Singapore, Norway, and a number of oil-exporting countries did long ago—dividing its reserves into a liquid component, for foreign exchange management, and an investment component, which could be placed in higher-yield, less-liquid portfolio investments abroad.

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The United States has unwisely created an environment in which the expectation of renminbi revaluation is widespread, and indeed it has become an issue, again unwisely, embraced by some members of Congress. Thus, China faces the question, with the US administration, of how to manage this issue smoothly, to create as little damage as possible. I suggest China respond with a three-part package, which does not involve the risky step of significantly revaluing the renminbi.

First, it should move with as much speed as such institution-building permits to build a functioning foreign exchange market, made by financial institutions rather than the central bank. Some steps have already been taken in this direction, but it will also involve creation of some significant difference between buying and selling rates for dollars by the PBC. The PBC's July 21 move to introduce a basket of currencies as a reference point and to allow intraday variation of the dollar rate, albeit with a maximum change of 0.3 percent a day, is a step in this direction.

Second, to help reduce the trade surplus, China could reduce some of its import tariffs and other remaining restrictions on imports at a pace faster and further than the reductions required (by the end of 2006) by China's accession to the World Trade Organization. China's import restrictions are modest compared with those of many other developing countries, but they are notably higher than those of the United States and Europe (except for some agricultural products), and they could usefully be reduced. The world is now engaged in the Doha Round of multilateral trade negotiations, and no country

wants to jeopardize its bargaining position in such negotiations. However, there is ample precedent for giving China “credit” in the Doha Round for any tariff reductions it undertakes unilaterally before the round and its subsequent 8 to 10 year transition period are completed.

Third, China should take steps to relax controls on the outward movement of capital, consistent with continuing steps to strengthen the domestic financial system. One natural way to do this, which seems to be happening, is to be less stringent in giving approval to Chinese firms that want to invest abroad. Such FDI involves management control, or at least participation

in management. China should also encourage passive portfolio investment abroad. This could start by permitting Chinese financial institutions such as insurance companies to invest a certain fraction of their portfolios abroad. Permission could then be extended to selling mutual funds of foreign securities, stocks, and bonds to Chinese residents, perhaps with initial restrictions, to be relaxed gradually, on the amount that could be sold.

All this would be preparatory to China’s eventual move to its stated objective—to have full currency convertibility, with greater exchange rate flexibility, some time in the future.

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