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Will Pinning the Blame on China Help Correct Global Imbalances?

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Many commentators in the West have jumped on the bandwagon lately to blame China for playing a leading role in causing the current global crisis, as well as for preventing a sustainable recovery. The criticisms often focus on what a prominent U.S. government representative has recently called 'exchange-rate manipulation'.

Since Martin Wolf, the well-known columnist of the *Financial Times*, has been noteworthy for lodging such criticisms of China, we begin our discussion with some of his remarks. Over the course of a series of columns starting in December 2008 as well as in his book (Wolf 2009), he has laid out a case for pinning the principal blame on China for global imbalances.

For example, in his representative column on January 20, 2009, he states that the global crisis is due to "the malign interaction between some countries' propensity towards chronic excess supply and other countries' opposite propensity towards excess demand" and stresses that "…the driving force behind these [global] 'imbalances' has been the policies of surplus countries and particularly China…".

Focusing more on the prospects of global recovery in his April 7 column (entitled tellingly "What the G2 Must Discuss Now the G20 Is Over"), he notes that "China must also understand an essential point: the world cannot safely absorb the current account surpluses it is likely to generate under its current development path".


Photo: E. French

In contrast to such an analysis, this Policy Brief argues that the main source of global instability is to be found in the US, the world's economically dominant, reserve-currency country—and its most profligate. The Brief also maintains that what is now most problematic is certainly not the current policy response of China to the crisis, but the difficulties faced by the US in correcting its own imbalances.

The US is currently trying to replace huge private-sector deficits (which were grossly inflated by the *domestically generated* stock-market and housing bubbles) with massive public deficits. Its fiscal deficit for 2009 is projected, for example, to reach about 13% of GDP.

However, such a fiscal effort will certainly not help correct the US's mammoth current-account deficits since it will surely boost imports. Only a precipitous decline in the US dollar could produce the necessary correction of the current account.

In recent weeks, the dollar's value has been in decline. But could the global economy afford a sharp drop of its chief reserve currency? Not likely, in part because many other currencies would be significantly appreciated in the process.

In recent years, even before the current crisis, the value of the US dollar was trending downwards. For example, between its high point in February 2002 and its low point in April 2008, the Fed's nominal broad dollar index fell by about 26%.

But between April 2008 and April 2009, the dollar appreciated, as the Fed index rose again by 15%. Despite the crisis (and despite low returns), foreign investors flocked during this period to US Treasury Securities as a 'safe haven'. Foreign governments have been the chief purchasers of these securities but private investors have not been far behind.

Now, in June 2009, the dollar is heading downwards again, in response apparently to the first glimmers of eventual economic recovery. Depreciation could certainly benefit the US since it enjoys the privilege of borrowing internationally in its own currency.

Hence, depreciation would reduce the value of US net foreign liabilities in the process.

In contrast, the governments that hold US Treasury Securities, China being prominent among them, would suffer from a 'devaluation' of their foreign assets. And if these governments tried to move their investments to other currencies, the dollar depreciation would accelerate and US interest rates would have to rise in response—precisely at a time when they should remain low to support recovery.

A Global Savings Glut?

The underlying cause of global imbalances has been a US 'over-consumption' binge—certainly not China's management of its exchange rate or its high savings rate. However, one of the major claims of critics of China is that by recently running enormous current-account surpluses, China is contributing to a 'global savings glut' (See Wolf 2009, p. 58). Since this mantra appears to cut across the spectrum of economists, from Martin Wolf to Ben Bernanke to Lawrence Summers, it merits closer examination.

Although widely accepted, does such a claim make sense? At the *global* level, it does not: global savings must equal, by definition, global investment (unless there are errors in estimation). Excess savings in one grouping of countries, such as Asia, must be balanced out by deficient savings in another part of the world, such as the US.

Table 1: Savings as a Ratio to GDP (%)

	1986-1993	1994-2001	2002-2008
Global	**22.7**	**22.1**	**22.7**
Advanced Economies	22.2	21.6	19.8
USA	16.3	17.0	13.9
Emerging and Developing Economies	24.3	24.2	31.1
Middle East	17.6	25.5	38.7
Developing Asia (including China)	28.8	32.7	41.2

Source: ADB, *Asian Development Outlook 2009*; and *IMF, World Economic Outlook 2009*.

Perhaps the China critics mean by 'glut' that global savings have been rising relative to global income. Table 1 shows that broad averages do not support such a claim. During 1986-1993, world savings as a ratio to world income was 22.7% while during 1994-2001 this ratio slipped to 22.1%. In the most recent period for which the IMF has data, namely, 2002-2008, the global savings ratio rose back up to 22.7%. This is, indeed, very weak evidence of a 'global savings glut'.

In the so-called 'Advanced Economies', the ratio of savings to GDP has, in fact, been falling since the late 1980s. While it was 22.2% during 1986-1993, it dropped to 19.8% during 2002-2008. The global savings ratio has managed to remain fairly constant only because the savings ratio in 'Emerging and Developing Economies' increased from 24.2% during 1994-2001 to 31.1% during 2002-2008.

As a result, these low- and middle-income countries have ended up exporting huge quantities of capital to the richest countries, predominantly the US. In other words, capital is 'flowing uphill' from poorer countries to richer countries, instead of staying where it is most needed (see McKinley 2006 for any early exposition of this problem).

As Table 1 highlights, the significant increase in savings in 'Emerging and Developing Economies' was due mainly to the increases in the Middle East and Developing Asia (including China). The former region has enjoyed the windfall of rising oil prices while the latter has been successful in achieving export-led growth.

Export-Led Surpluses

Countries adopting an export-led model are more likely, if successful, to run current-account surpluses. There is nothing malign about choosing such a strategy. Japan and Germany remain prominent examples. During 2006-2008, the former's current-account surplus averaged 4% of GDP while the latter's averaged 6.7%. The East Asian Tigers, such as Singapore and Taiwan POC, have also followed this path with great success, emulating Japan's earlier example.

Only recently has China also begun to run large current-account surpluses. During 2006-2008, its average surplus was about 10% of GDP, which is indeed high for such a large economy. But as recently as 2001-2003, this average had been only about 2%.

Until the mid 2000s, there appears to be no notable correlation between the size of China's current-account surplus and that of the US's current-account deficit. Figure 1, which charts the current-account trend of China against that of the US, shows that there is little meaningful connection between the two until very recently.

The US's tendency to run sizeable current-account deficits dates from the early 1990s, when China's current-account surpluses were still negligible. In other words, the US's propensity to 'live beyond its means' was well entrenched long before China became a significant exporter of capital.

Moreover, the structure of China's trade has been undergoing significant change during the 2000s. In 2000, about one third of China's exports went to Developing Asia, about 53% went to the US, Japan and the European Union and the remaining 14% went to 'Other Countries'.

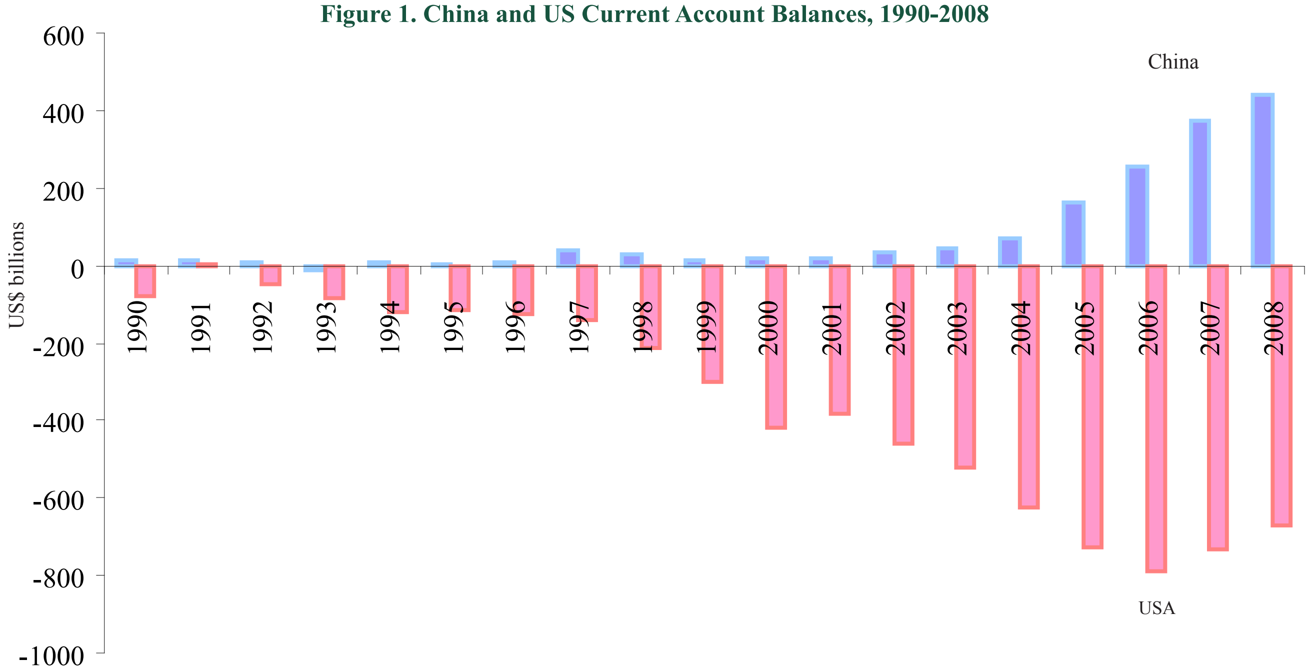
However, by 2007, while the share of China's exports to Developing Asia remained roughly the same, its share going to the US, Japan and the European Union dropped by 15 percentage points to about 38% while its share going to 'Other Countries' rose to almost 29%.

The share of China's exports shipped to the US declined from about 20% in 2000 to about 16% in 2007 (*Asian Development Outlook 2009*, Table A11). This being the case, the Chinese policy of pegging its renminbi to the dollar does not make a great deal of sense—nor does pumping reserves into US securities in order to abate depreciation of the dollar. China is bound to abandon such an increasingly ineffective and risky strategy, and appears already to have taken steps to do so.

China's Development Model

As a result of the debate on its exchange-rate policies, China's development model has lately been subjected to considerable criticism from commentators in the West. However, in many respects its remarkable success speaks for itself. For example, while in 1980 China's GDP per capita was only $ 807, by 2008 this meas-

Figure 1. China and US Current Account Balances, 1990-2008



Source: IMF, World Economic Outlook database.

ure had increased by over ten-fold to $ 8,539 (in constant prices).

Between 1981 and 2005, China managed to lift almost 630 million people out of poverty (according to the World Bank's $ 1.25 per day international measure). Thus, its incidence of poverty plummeted during this period from about 84% of the total population to about 16%.

China's choice of development model has historical roots in the success of the earlier East Asian Tigers and, before that, Japan. Choosing this option has also been deeply influenced by the traumatic experiences of the Asia Financial Crisis in 1997-1998.

Adopting an export-oriented growth strategy relies critically on maintaining a competitive exchange rate. Hence, managing the exchange rate—such as through a 'soft peg'—makes sense. Not surprisingly, exchange-rate management is widespread among developing countries. Nonetheless, a country needs to have amassed a sizeable and diversified stock of foreign-exchange reserves in order to have success in such a strategy. And it must also be able to sterilize any domestic monetary impact of such reserves.

The countries in Asia that had earlier liberalized their trade and capital flows learned some bitter lessons from the Asia Financial Crisis. One was that they must avoid, at all costs, running current-account deficits, especially if such deficits are financed by short-term external borrowing.

One after the other, these countries confronted speculative attacks on their currencies when they had difficulties in servicing their external loans. Reluctantly, many had to turn to the IMF to bail them out of their financial crises. They thus suffered from the humiliation of being compelled to comply with a lengthy and onerous list of restrictive IMF conditionalities.

Once recovered from the crisis, these countries began a concerted effort to consistently run current-account surpluses, and started accumulating foreign-exchange reserves as insurance against speculative attacks on their currencies. Although China had escaped the worst consequences of the Asia Financial Crisis, it had learned nonetheless some of the major lessons from that experience.

Current Accounts and Reserves

Between 2004 and 2007, East Asia's current-account surplus rose from about $ 132 billion to about $ 436 billion (ADB 2009). China's surplus (e.g., about $ 372 billion in 2007) dominated this aggregate, although Hong Kong, China and Taiwan POC also consistently contributed surpluses. By 2007 China's stock of gross international reserves had reached over $ 1.5 trillion, and was still increasing. The combined reserves of Hong Kong, China and Taiwan POC had reached about $ 423 billion in 2007.

Between 2004 and 2007, Southeast Asia's current-account surplus also rose, from about $ 42 billion to about $ 98 billion. This reflected mainly the contributions of Indonesia, Malaysia, Singapore and Thailand. The combined stock of gross international reserves of these four countries alone had reached about $ 409 billion in 2007.

Thus, the trends of China's current account and international reserves mirror those of many of the export-oriented economies in East and Southeast Asia. The difference is that China's surpluses and reserves have been growing particularly rapidly in recent years and are huge in absolute magnitude.

Though the combined current-account surpluses of Germany and Japan exceed those of China, few economists or politicians in the West are heaping blame on them for global imbalances. In 2007, for instance, the combined current-account surplus of Germany and Japan was about $ 464 billion while that of China, as mentioned above, was $ 372 billion.

The main difference between these advanced economies and China seems to be that China is realigning the global balance of economic and political power while Germany and Japan are not. The latter have been running large current-account surpluses for a long time without having triggered significant opposition from the US or other advanced economies.

Martin Wolf's explanation is that these two advanced economies are 'structurally mercantilist' while China has 'mercantilist policies' (December 2, 2008 FT column). Though this distinction remains murky, the implication appears to be that China has a choice: it can allow its currency to appreciate and significantly reduce its surpluses. But the above distinction is a misleading characterization of the underlying forces at work.

The Sources of Chinese Savings

China's current-account surpluses are directly related, through macroeconomic accounting, to 'excess' domestic savings—i.e., a surplus of domestic savings relative to domestic investment. Hence, it is important to examine why China has a high savings rate and whether it is 'excessive'.

Table 2: Investment and Savings in China, 1990-2007 (% of GDP)

	1990-1994	1995-1999	2000-2004	2005-2007
Gross Domestic Savings	41.2	42.0	41.1	52.4
Gross Capital Formation	39.5	38.8	38.7	44.1
Difference between the Two	1.7	3.2	2.4	8.3

Source: World Bank, World Development Indicators database.

As Table 2 shows, China's gross domestic savings rate averaged over 52% of GDP during 2005-2007, a jump from about 41% during 2000-2004. This is, indeed, very high. However, China has been both a high-savings and a high-investment economy for a long time. For instance, during 2005-2007, its gross domestic investment rate was about 44% of GDP, while it had been close to 40% for many years before then. Such high rates help explain the country's very rapid pace of growth.

The problem is that while both China's savings and investment rates have been on the rise, the gap between the two, namely, its 'excess savings', has recently been widening. During 2005-2007, this gap had enlarged to 8.3 percentage points whereas it had been only 2.4 percentage points during 2000-2004. Why has this been the case?

China has a high domestic savings rate for several 'structurally' important reasons. The proposition that China saves 'too much' because of its 'mercantilist' exchange-rate regime is simple-minded and disingenuous. It is indeed true that its 'excess savings' are associated directly with its current account surplus. But the mechanical application of macroeconomic accounting cannot substitute for a concrete analysis of underlying behavioural relationships.

Other important factors have been driving savings. China's very rapid rates of growth have certainly boosted savings, as has been the case in other fast-growing economies. In recent years the biggest increases in national savings in China have been due not to rising household savings, but to the enlargement of corporate retained earnings, which now account for about 60% of all savings.

Corporate retained earnings have also been rising in the US, as incomes have been transferred from labour to capital, but the major difference is that US households have been dis-saving on a dramatic scale.

Other major factors, which specifically raise Chinese precautionary savings, originate in the insecurities inherent in the country's transition to a more market-based economy. Such effects are particularly pronounced among urban households.

For example, household expenditures on health insurance and education have had to rise significantly as the state has abandoned its earlier socialist commitments. Also, households can no longer rely on the security of old-age pensions, which had previously been tied to the employment of their members in state-owned enterprises (ADB 2009, pp. 91-92). Also, urban unemployment has been on the rise as SOEs have restructured into more commercial enterprises.

But households have also been able to save more because of declining family size. The decisive demographic impact of China's long-standing one-child policy is often neglected in these discussions.

Expected Changes

China's unprecedentedly high savings rate will undoubtedly begin to decline. The knock-on effects of the global recession will surely lower corporate retained earnings as well as reduce the current-account surplus as a result of declines in export earnings.

Also, it appears that China started running deficits on its capital account in 2008 as it began to export capital to other countries, particularly those with substantial resource endowments. Between 1999 and 2007, in contrast, China had run surpluses on its capital and financial account, powered mostly by continuous inflows of net direct investment that amounted to 2-4% of GDP. China's recent shift to capital exports could represent a momentous change of its international strategy, which could significantly alter the global economic landscape.

In a related development, China has already begun to diversify out of the dead-end of US-denominated reserves and promote the renminbi as a medium of exchange for trade relations (such as with Brazil). China cannot afford to continue investing large sums in low-return and increasingly risky US assets.

Also, the country is implementing one of the largest fiscal stimulus packages in the world, estimated at about 5% of China's GDP. This compares favourably to the US stimulus package, which, at 2% of US GDP, is much lower in relative terms. China's stimulus—which is concentrated in development-oriented investment—will certainly spill over into increases in domestic consumption and result in higher imports.

In summary, this Policy Brief has stressed that there are good reasons why China has followed its export-oriented development strategy and why it has a high savings rate. Its policies have been neither mercantilist, Machiavellian nor malign. In many ways, its strategy has been a remarkable development success. And its actions have certainly not been the motive force behind global imbalances.

It is worthwhile remembering that the great majority of Chinese are still relatively poor by developed-country standards. Despite having an average GDP per capita estimated to be $ 8,539 in 2008, this level is just a little over one fifth of the US GDP per capita of $ 38,277. Yet China has been exporting capital to the US to finance the latter's systematically worsening excess consumption. This inequitable transfer of resources is already in the process of being corrected, thanks in part to the global recession.

The Drivers of US Consumption

Despite many eminent opinions to the contrary, this Policy Brief has argued that the US should be regarded as the central source and the 'driving force' of the current exacerbated state of global imbalances. Trying to shift the blame onto China serves only to cloud this reality. The main global focus now should be on how US structural adjustment, set within the context of a global recession, could be carried out to reduce the basis for future global imbalances.

Knowing how the US originally got into crisis would help us understand how it could attempt now to extricate itself. So, what were the domestic 'drivers' of the US 'over-consumption' binge? We bring this Policy Brief to a close with such a discussion.

Because the US began to run sizeable current-account deficits in the early 1990s and the Clinton administration began in the 1990s to substantially reduce the large fiscal deficit inherited from the Reagan era, the private sector had to supply the compensating aggregate demand to sustain economic growth (see Izurieta and McKinley 2006 for an analysis of the roots of impending US crisis).

As the corporate sector oscillated between small surpluses and small deficits, the household sector began spending well beyond its level of income. As a result, the net savings of the household sector declined from a surplus of well over 3% of GNP in the early 1990s to a deficit of about -4% of GNP by the turn of the century. Households were increasingly borrowing to sustain higher levels of consumption and residential investment (Izurieta and McKinley 2006).

Why did US households feel confident about borrowing so heavily? Their personal assets, such as equities and housing stock, were also rapidly appreciating. As long as asset appreciation kept pace with the rise of household liabilities, continuing increases in household consumption appeared sustainable.

But, as we now know, the stock-market bubble burst in 2001. The US Government was initially able to contain the shock through expansionary fiscal and monetary policies. One important consequence was that interest rates remained historically low. But this policy stance had the undesirable side-effect of further fuelling the real-estate bubble. By 2007-2008, the continued inflating of this latter bubble obviously reached its limits.

During the current crisis, the US household sector is rehabilitating its savings, banks are rebuilding their balance sheets and the corporate sector is refraining from investing. Meanwhile, persistently large US current account deficits exert a heavy drag on aggregate demand. Hence, running historically large fiscal deficits, backed by monetary stimulus, has had to become the main source of aggregate demand for US economic recovery.

However, such a stimulus package remains inadequate to the task at hand, and could eventually generate counter-productive effects. Eventually, the fiscal deficits will have to be reduced. More important in the medium term is achieving a slowdown in household and corporate debt.

But most critical in the longer term would be US success in regaining international competitiveness. Otherwise, its employment would remain heavily reliant on domestic credit expansion and ballooning budget deficits, and on the continuing infusion of other countries' savings to finance a seemingly intractable current account deficit.

The recent clamour in the West about China's so-called 'exchange-rate manipulation' only serves to mask the underlying reality that the US has lost its previous edge in international competitiveness. A sharp depreciation of the US dollar—which would have, in any case, a deleterious impact on the global economy—could not solve, by itself, this fundamental problem.

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