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With Reforms in China, Time May Correct U.S. Current Account Imbalance

by Jian Wang

Outside pressure to appreciate the yuan could increase China's resistance to reforming exchange rate policy and financial markets.

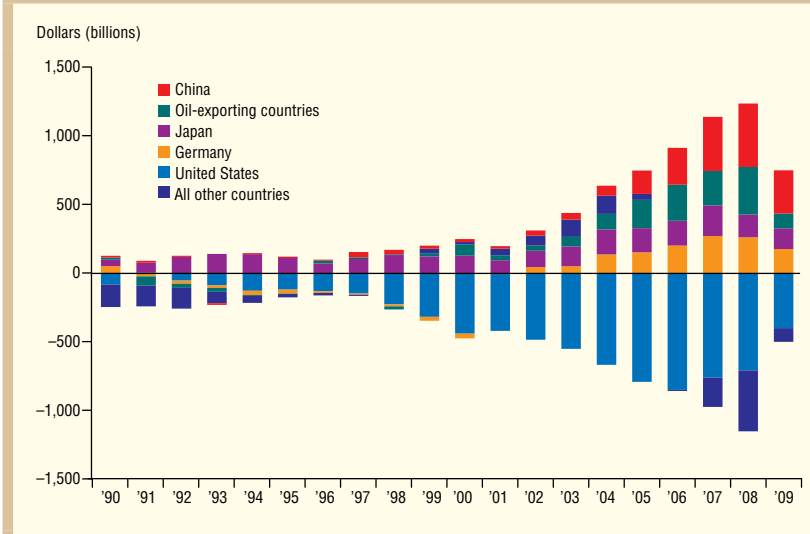
The U.S. current account deficit has deepened significantly since the late 1990s. This shortfall—the value of net exports of goods and services, international financial investment net income and transfer payments—was $803 billion at its peak in 2006, or 6 percent of U.S. gross domestic product (GDP). Conversely, China, Germany, Japan and the oil-exporting countries have been running current account surpluses that have risen substantially (*Chart 1*). This divergence has raised concerns among policymakers, economic researchers and private investors about whether these imbalances are sustainable and at what risk to the global economy.

In theory, current account imbalances do not necessarily indicate economic danger. If a country is expected to grow more rapidly in the future, running a current account deficit is an optimal behavior. The country should borrow now from the rest of the world to finance current consumption and repay the money later when it has greater means. For instance, Europe ran a current account deficit while rebuilding after World War II.

A large share of the U.S. current account deficit before 2005 was with other industrial countries, such as Germany and Japan. This behavior makes economic sense, argue Charles Engel, a University of Wisconsin–Madison economics professor, and John Rogers, a Federal Reserve Board economist.[1] These trade deficits/surpluses simply reflect the difference in growth prospects between the U.S. and other major industrial nations. Since the mid-1970s, economic expansion in the U.S. has outpaced that of other industrial countries. GDP on average grew 2.82 percent in the U.S. between 1975 and 2009, compared with 1.87 percent for Germany and 2.33 percent for Japan. If the U.S. continues to outperform other industrial countries, it is optimal to borrow from these nations now and incur a

Rather than an undervalued currency, China's ballooning current account surplus may reflect deeper structural distortions in its economy.

Chart 1
U.S. Current Account Deficit Continues



SOURCES: International Monetary Fund; Haver Analytics.

current account deficit. Assuming that the difference in economic growth between the U.S. and other industrial countries over the past 30 years continues for another 20 years, Engel and Rogers found that a standard economic model could justify a U.S. current account deficit at its 2004 level, the end of the period covered in their research.

Demographic differences also factor into account imbalances. The populations of several industrial countries, including Germany and Japan, are aging more rapidly than the population of the U.S. The need to support future retirees provides an incentive for these countries to save and incur current account surpluses with the U.S.

The Role of China's Yuan

Oil-exporting countries and fast-growing Asian economies, particularly China, began playing an increasingly important role in global current account imbalances in 2005. The substantial increase among oil-exporting countries after 2005 is mainly due to rising energy prices. China's current account surplus rose to $436.1 billion (9.88 percent of GDP) in 2008 from $68.7 billion (3.55 percent of GDP) in 2004, though the genesis of that gain is at first glance puzzling.

Normally, a fast-growing economy such as China would borrow money from the rest of the world instead of lending. An obvious suspect in China's mounting current account surplus is the fixed exchange rate between its yuan and the dollar. An undervalued yuan makes Chinese products cheaper than those of competitors in international markets. As a result, China exports more than it imports. According to this explanation, yuan appreciation could rebalance the global economy. This argument has at least two flaws.

First, the durability of the U.S.–China imbalance is difficult to explain. In order for the exchange rate to affect import prices, those prices can't adjust. For instance, assume that the People's Bank of China undervalues its currency 10 percent to make Chinese products 10 percent cheaper than they otherwise would be. If Chinese producers could change their prices immediately, they would increase prices 10 percent

to offset the undervaluation. Although in reality prices cannot change instantly, they do adjust over the long run; therefore, the exchange rate has only short-term effects on import prices and the current account. China has run a significant trade surplus against the U.S. for about 10 years (*Chart 2*). It is hard to imagine that prices have not fully adjusted to offset the exchange rate after such a long period.

Second, an appreciating yuan may only minimally reduce the imbalance. Even in the short run, the exchange rate's impact on import prices would be quite limited, studies have shown. Exporters usually pass on only a fraction of exchange rate movements when setting prices. About 20 percent of exchange rate changes were reflected in U.S. import prices during the past decade, Federal Reserve economists Mario Marazzi and Nathan Sheets found.[2] Profit margins usually absorb some of exchange rate movement as exporters seek to maintain market share.

Additionally, the currency under which import prices are invoiced also affects the exchange rate pass-through. Most U.S. imports from China are priced in dollars, and their prices are fixed in the short run. In this case, depreciation of the dollar against the yuan has no short-run effect on import prices from China.

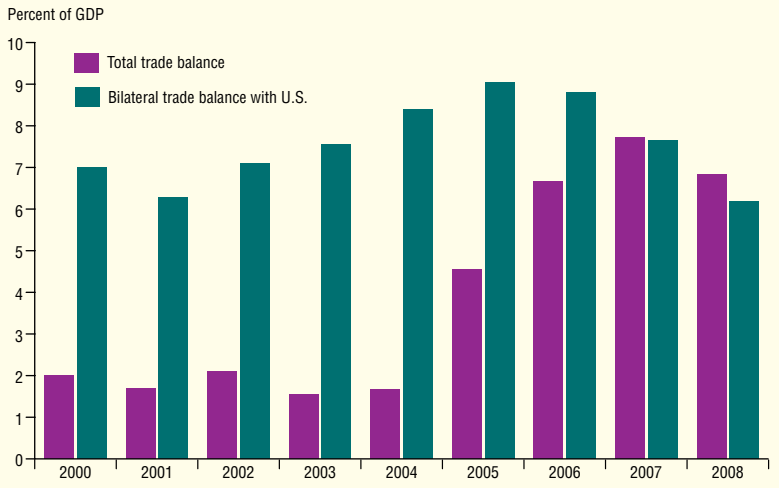
Effect of Structural Distortion

Rather than an undervalued currency, China's ballooning current account surplus may reflect deeper structural distortions in its economy. Chart 2 shows that China's total trade account balance began to move up in 2005, though the bilateral trade surplus with the U.S. began much earlier.

High household savings is a suspected cause of China's massive current account surplus. However, corporate and government savings have played a more important role (*Chart 3*). The amount of household savings as a percentage of disposable income has been stable since the 1990s, although the savings rate is high relative to that of industrial countries. Corporate and government savings have increased substantially compared with the household rate since 2004—when the current account surplus began expanding.

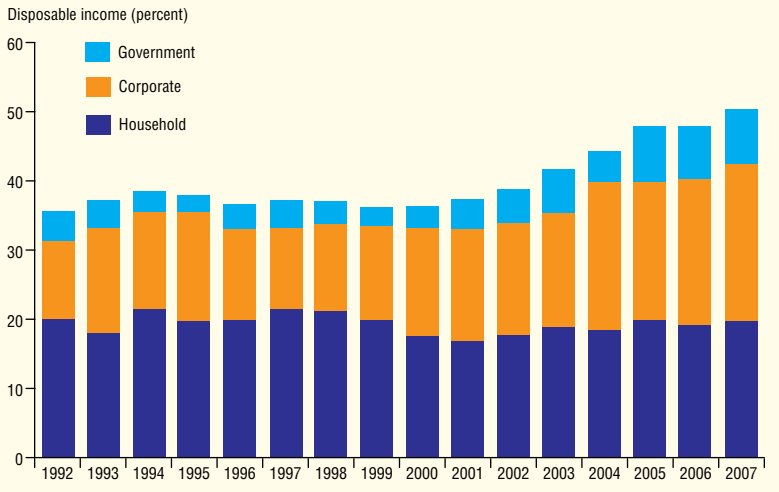
The corporate and government savings increases were accompanied by a shift in the composition of state-owned enterprises. During this period, state-owned corporations exited from industries with low profit margins, such as textiles. Meanwhile, state-owned

Chart 2
China's Trade Imbalances Persist



SOURCES: Census Bureau; Haver Analytics.

Chart 3
Corporate and Government Savings Increase in China



SOURCE: People's Bank of China.

corporations continue to dominate and crowd out private companies in industries with higher margins, such as finance, energy, telecommunications, transportation and real estate. This leadership of state-owned corporations is not a result of market-based competition. Instead, it is a product of favorable government treatment, including easy access to credit and advantageous loan terms from state-owned banks. The government also erected policy barriers to prevent private entry into these industries.

The booming global economy around 2005 boosted China's corporate profits. Earnings in the high-margin industries were transformed into savings because the government lacked channels to redistribute them for household consumption. In the long run, this structural economic distortion should be corrected to balance China's current account surplus. Financial-sector reform and removal of entry barriers in industries dominated by state enterprises will decrease the corporate savings rate. Authorities should also increase competition in these now highly regulated industries, promoting efficiency and economic growth in the long run.

Steps to Balance Economy

In the shorter term, boosting government spending on the social safety net may effectively reduce China's current account surplus. Increasing such expenditures not only can directly decrease government savings but also reduce overall household savings through shared risk.

The Chinese government has officially acknowledged a need to balance its economy, listing increased domestic spending as one of the most important issues in its 12th Five-Year Plan (2011–15). Yi Gang, deputy governor of the People's Bank of China, said in October that China would reduce its current account surplus to less than 4 percent of GDP within three to five years—a target proposed by U.S. Treasury Secretary Timothy Geithner.[3] China also recently passed the Social Insurance Law, laying the foundations for its social safety net. Social welfare programs such as retirement, basic health care and unemployment insurance coverage will be created. Such programs have been difficult to establish in China in the past.

Structural changes will require time to implement, and the current account imbalance between China and the U.S. may continue. Policies attempting a quick fix may produce unintended consequences. Outside pressure to appreciate the yuan could increase China's resistance to reforming exchange rate policy and financial markets—both crucial to addressing this massive country's structural economic issues.

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Notes

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[1] See "The U.S. Current Account Deficit and the Expected Share of World Output," by Charles Engel and John H. Rogers, *Journal of Monetary Economics*, vol. 53, no. 5, 2006, pp. 1063–93.

[2] See "Declining Exchange Rate Pass-Through to U.S. Import Prices: The Potential Role of Global Factors," by Mario Marazzi and Nathan Sheets, *Journal of International Money and Finance*, vol. 26, no. 6, 2007, pp. 924–47. Marazzi later became executive director of the Puerto Rico Statistics Institute.

[3] See "China to Cut Current Account Surplus Through Gradual Adjustment, Yi Says," by Ye Xie, Bloomberg, Oct. 9, 2010.

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