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Global imbalances and the Chinese balance of payments

*Hansjörg Herr**

After the start of reform in 1978 China became one of the most successful developing countries in the world economically.¹ China did not follow the philosophy of neoclassical development models upheld by the Washington Consensus and the savings-gap model. In fact, the Chinese miracle is unthinkable without a strong developmental state and the non-acceptance of long-term deficits in the current account. It is in keeping with the tradition of an Asian development model, as exemplified by Japan and later the smaller and bigger Asian tigers. One of the success factors of the Chinese 'miracle' is the export orientation of the Chinese economy.² Along with others, China became one of the countries with huge current account surpluses.

The Chinese current account surplus

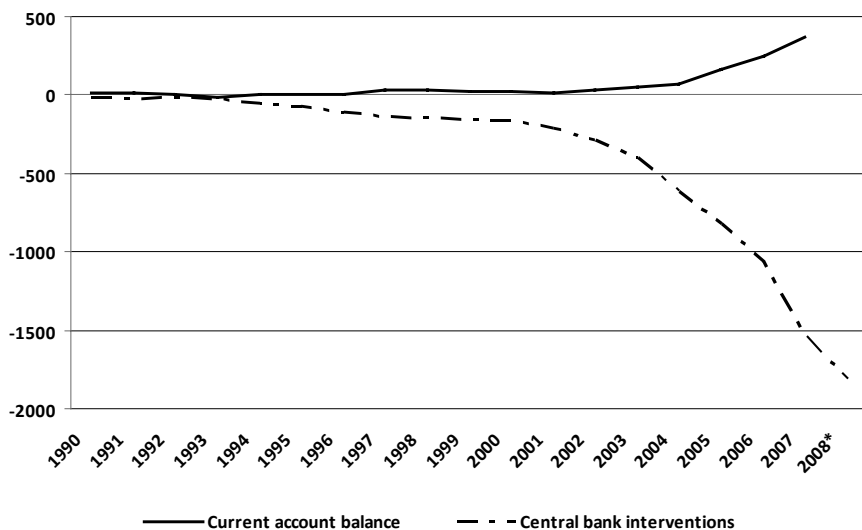
Generally speaking, from the beginning of the reforms until the mid 1990s the Chinese current account was balanced. After the mid 1990s current account surpluses increased and became permanent. Figure 1 reveals that Chinese current account surpluses started to take off in 2004, whereas central bank interventions in the foreign exchange market had already started to increase by the mid 1990s and continued to increase sharply. The People's Bank of China (PBoC), the Chinese central bank, intervened in the foreign exchange market in an extreme, unprecedented way not only to finance the current account surplus but also to compensate net capital inflows. It is frequently argued that cheap Chinese wages are responsible for high Chinese current account surpluses. If real wages are meant, why then can countries with even lower real wages have current account deficits? If nominal wages are meant, it is the nominal exchange rate which makes the wages of a country low in comparison to other countries. In China, the PBoC has kept the Chinese renminbi (RMB) undervalued to allow for current account surpluses. Without the PBoC's interventions China would be pushed into a constellation of high current account deficits. The Chinese motivation for a surplus policy is clear: Without the high current account surpluses, aggregate demand and GDP would be substantially lower and unemployment higher. China uses exports as a demand engine to stimulate domestic growth.

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1 Between 1978 and 2008 the average annual real GDP in China (mainland, without Hong Kong) increased spectacularly by nearly ten per cent and GDP per capita by over 8.5 per cent (China Statistic Yearbook 2008).

2 In 2006 exports of goods and services reached over 40 per cent of GDP in China. Before 2002 it was around 20 per cent and in the early 1980s around ten per cent (China Statistic Yearbook 2008).

Figure 1: Current account balance and central bank interventions in billion US dollars from 1990 – 2008*



* Until 01.06.2008

Source: State Administration of Foreign Exchange of the People's Republic of China 2008, China Statistic Yearbook 2008

The biggest bilateral current account and trade surplus of China is vis-à-vis the United States, while the European current account deficit against China is increasing. However, China achieves current account deficits vis-à-vis Japan and other Asian countries which depreciated their currencies heavily during the Asian crisis in 1997.³ Because of this trade constellation China has become a growth engine for the Asian region.

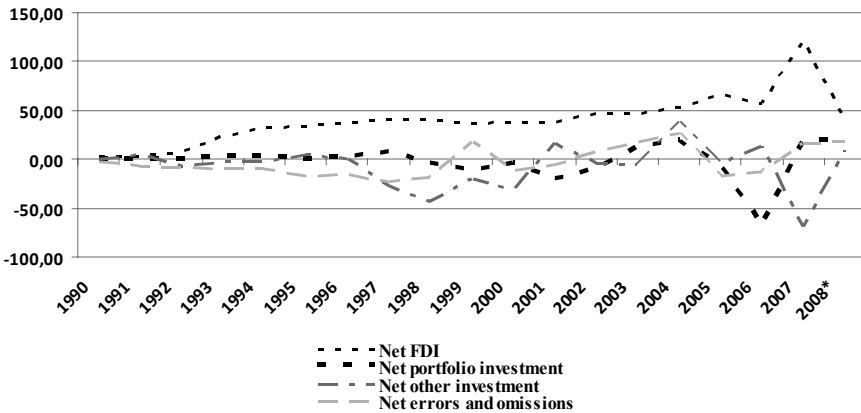
Until recently, China had implemented a comprehensive system of capital controls which has only been relaxed a bit in the past few years. The logic of the capital control system is simple: all types of capital flows are strictly controlled with the exception of foreign direct investment (FDI) inflows. In the 1980s capital flows in China were negligible. In the early 1990s FDI inflows to China jumped to high and stable levels and increased even after 2001. Compared with other developing countries net portfolio flows and other net capital flows (international bank credits) remained relatively small (cf. Figure 2 on the next page). In June 2008 foreign debt in China was only 427 billion \$, slightly above ten per cent of GDP.⁴ In China, firms, public households and banks were restricted in the inflow of hard

3 In 2006 China had a trade surplus vis-à-vis the USA of 144 billion \$ and vis-à-vis Europe of 101 billion \$. In the same year it had a deficit vis-à-vis Japan of 24 billion \$ and the rest of the world of 43 billion \$ (China Statistical Yearbook 2007).

4 Cf. China Daily 10.08.2008, based on publication of the State Administration of Foreign Exchange.

currency which could be used to finance a current account deficit or used for capital export (or rather, capital flight) by other units like private households.⁵ All in all, capital controls have worked. To a large extent, China was able to structure capital flows in its own interest, follow a domestic orientated monetary policy and never suffered from a currency crisis – a privilege not shared by many developing and even developed countries in the world (Prasad/Wei 2005, Herr 2008). China is an immature net creditor country. Chinese foreign monetary wealth is denominated in US dollars and other key currencies. This means that appreciations of RMB lead to negative wealth effects and can destroy the equity of Chinese holders of foreign wealth. It can also lead to quick and substantial portfolio shifts from foreign currency to domestic currency inside the country. The lion's share of foreign Chinese assets is kept by the PBoC which would not really suffer if the domestic value of foreign reserves were even significantly reduced. Singapore, another immature net creditor country, solved the problem by creating two sovereign wealth funds which kept most of its foreign wealth. China followed this strategy when it created the China Investment Corporation in 2007 which received 200 billion \$ from the foreign reserves held by the PBoC (McKinnon/Schnabl 2008). What is important here is that the RMB can appreciate without large negative wealth effects for the Chinese private sector.

Figure 2: Foreign direct investment, portfolio investment, other investment (net flows), errors and omissions in billion US dollars, 1990 – 2008*



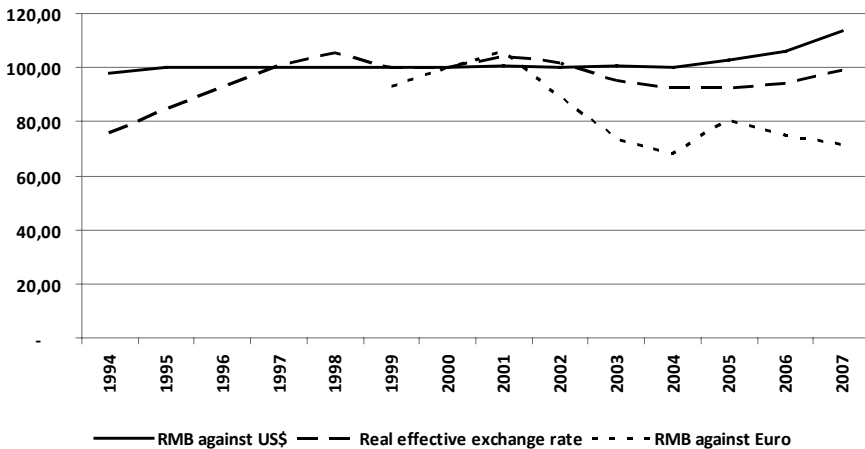
* Until 01. 06. 2008

Source: State Administration of Foreign Exchange of the People's Republic of China 2008

5 Russia is a good example of a country with high capital inflows to finance high capital outflows. After the start of the Russian transition in the early 1990s and due to oil and gas exports Russia never had deficits in the current account. In spite of this the country accumulated a huge gross debt in foreign currency. When the rouble exchange rate collapsed in 1998 the Russian financial system was wiped out. This can happen again. In spite of the huge Russian current account surpluses in recent years Russian foreign debt was around 28 per cent of GDP at the end of 2007 (World Fact Book 2008).

China has experimented with several exchange rate regimes. In 1981 a dual exchange rate regime was established, which fixed different exchange rates for different types of transactions. In 1985 the exchange rate for international trade was allowed to float. Beginning in the late 1980s this exchange rate started to depreciate sharply and lost nearly 50 per cent of its value vis-à-vis the US dollar. In 1994 China pegged the then unified exchange rate unofficially to the US dollar at a level which made Chinese products internationally competitive. In line with increasing Chinese current account surpluses, pressure to appreciate the RMB intensified, especially from the United States. ‘China bashing’ worked, and in 2005 China pegged the RMB to an (unknown) basket of currencies, allowing for a continuous and moderate appreciation of the RMB vis-à-vis the US dollar. It is noteworthy that, over a long period, and also after switching to a crawling peg, the RMB depreciated substantially vis-à-vis the euro (cf. Figure 3). The real effective exchange rate of RMB was about the same in 2007 as at the end of the 1990s. It would be wrong to speak of a substantial appreciation of the RMB after 2005.

Figure 3: Exchange rate between US dollar, Euro and Chinese Yuan (RMB) and the real effective exchange rate of RMB 1994 – 2007 (Indexes 2000 = 100)*



* Increase is an appreciation

Source: *International Financial Statistics, International Monetary Fund 2008*

Starting in 2002 China attracted very high capital inflows coming from high FDI inflows, financial inflows connected with FDI like credits between foreign parent companies and subsidiaries in China, and also illegal capital inflows. The latter are reflected in errors and omissions. Before and after the Asian crisis in 1997 errors and omissions indicated illegal capital outflows. Wealth owners in this period obviously expected that China would join other Asian countries and devalue the RMB substantially. In 2002 and thereafter, errors and omissions showed high illegal capital inflows for some years (cf. Figure 2). The explosion of

the Chinese current account surpluses in recent years probably also reflects illegal capital inflows, as exporters have artificially increased export prices and reduced import prices to transfer funds to China. According to Zhang and Xu's (2008) calculation the stock of speculative money in China (hot money from trade surplus, non remitted profits, FDI inflows etc.) increased from 140 billion \$ in 2004 to 541 billion \$ in 2007.⁶ Speculative capital inflows are triggered by expectations of a further and faster appreciation of the RMB. Current account surpluses and non-speculative capital inflows in China have simply become too big to believe that the crawling peg regime established in 2005 is sustainable.⁷

The conundrum is that Chinese current account surpluses did not become smaller in spite of a (moderate) real appreciation after 2005. Obviously, for political reasons an exchange rate target for the RMB was chosen which created huge current account surpluses and the PBoC was forced to intervene in the foreign exchange market without quantitative limits to reach the exchange rate target. It is frequently argued that savings in China are too high and that this is the explanation for the Chinese current account surpluses. Savings in China are high, albeit not really the explanation for the interventions of the PBoC. If there is a relationship between current account surpluses and domestic savings, then it is the other way round. Current account surpluses created by the PBoC stimulate domestic income creation, and in this way savings.

One noteworthy point is that China has been able to successfully sterilise huge central bank interventions. Firstly, the PBoC issued its own debt-securities in domestic currency which were bought by the domestic financial system. Secondly, minimum reserve requirements were increased continuously. Although sterilisation can become costly for a central bank, the demand stimulation which is created by central bank interventions can more than compensate the costs of sterilisation.⁸

Chinese surpluses and the world economy

There is no doubt that China's current account surpluses are harmful for economic growth in other countries. However, during the last decade countries like Germany and Japan have achieved surpluses of comparable magnitude. And a relevant number of developing countries followed the Chinese strategy of stimulating exports by central bank interventions (cf. Figure 4). After 2005 Chinese surpluses increased sharply and became the biggest in the

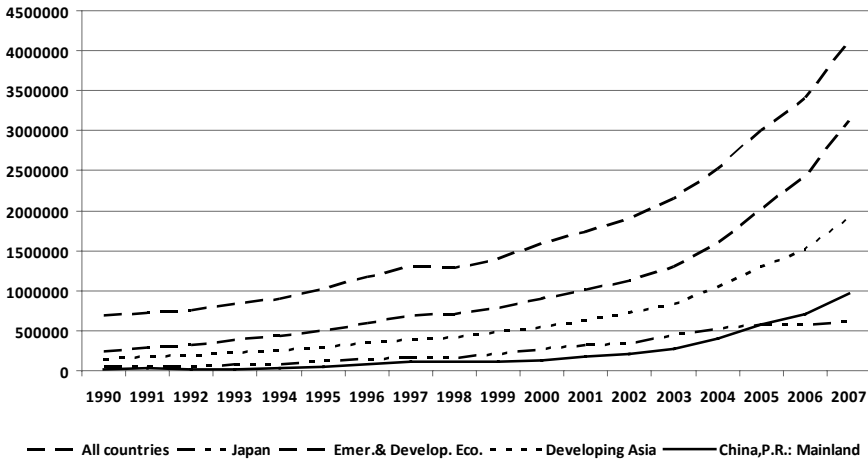
6 The Chinese State Administration of Foreign Exchange believes that the stock of speculative money is substantially lower.

7 McKinnon and Schnabl (2008) believe that the crawling peg stimulates capital inflows to China and a step to fix the RMB exchange rate again at the present exchange rate and at the same time to give up 'China bashing' would stop speculative capital inflows. This argument is not convincing. Chinese surpluses are too big to be sustainable.

8 For long periods sterilisation costs did not exist in China as the PBoC yielded higher interest rates for reserve holdings in foreign countries than it had to offer for its own debt-securities issued.

world.⁹ Nevertheless, it would be unfair to blame China as the key problem in the world economy when developed countries like Germany and many other developing countries also follow an export-oriented strategy.

Figure 4: Official reserves in million Special Drawing Rights 1990 – 2007



Source: *International Financial Statistics, International Monetary Fund 2008*

Not all countries in the world can follow a mercantile strategy, as the sum of all current account imbalances in the world is zero. The main problem of a group of countries with high current account surpluses is that they use export promotion to stimulate their domestic economies and export low growth and unemployment.¹⁰ Only if countries with current account deficits were to produce under full capacity utilisation and/or full employment, or if deficit countries are able to compensate the lack of demand created by current account deficits by stimulating domestic demand, would current account surplus countries do no harm to the output and employment in deficit countries. But these are very special and rare cases. From a global perspective a group of countries which actively strives for current account surpluses most likely reduces GDP growth in current account deficit countries, for example, if they are hit by a currency crisis. The reduction of growth in deficit countries reduces their imports and negatively affects growth in surplus countries. If all or even most coun-

9 In 2008 China had a current account surplus of 363 billion \$, Germany of 185 billion \$, Japan of 201 billion \$, Saudi Arabia of 89 billion \$ and Russia of 69 billion \$. The United States had a deficit of 747 billion \$, the United Kingdom of 111 billion \$ and Central and Eastern Europe of 164 billion \$ (World Fact Book 2008).

10 Germany realises most of its surpluses in Europe and thus has become a major problem for the coherence of the European Monetary Union (Herr/Kazandziska 2007).

tries in the world strive for current account surpluses, a worldwide coordination problem is created which most likely will reduce world growth.¹¹ However, there is a ›solution‹ for this worldwide coordination problem: a consumer of last resort. A consumer of last resort passively accepts current account deficits, manages to keep domestic growth relatively high by domestic demand stimulation, and in this way increases world GDP growth. Since the 1980s and especially since the 1990s the United States has taken over this function and has experienced huge current account deficits. The USA was pushed into this constellation by large capital imports which, for a substantial part, came from interventions in the foreign exchange market by central banks around the world (Summers 2004).

The function as a consumer of last resort can only be assumed by a country which is big, produces one of the world's key currencies and is the heart of the global financial market. No country in the world other than the USA could have accepted and at the same time produced such huge current account deficits. As a mature international debtor country the USA is able to become indebted in its own domestic currency. This is a significant privilege, because in spite of its own huge foreign debt, the USA cannot become over indebted in foreign currency, and for this reason does not suffer from the ›fear of depreciation‹. For a long time the USA was able to combine large current account deficits and high GDP growth – one of the conditions for taking over the function of the consumer of last resort. Growth in the USA was supported by an expansionary fiscal policy and by a policy of very low interest rates (Stiglitz 2006: 250). It would go too far to make China and other surplus countries responsible for the subprime crises which developed during the boom after the US slowdown in 2001 and 2002.¹² However, without the lack of demand caused by the huge current account deficit, interest rates in the USA would not have been as low after 2001 as they were.

With the outbreak of the subprime crisis in 2007 the USA may no longer be able to continue its function as the consumer of last resort, and may have much less room to manoeuvre in the foreseeable future. There are also no other countries which would be able to take over this function from the USA. Europe and Japan suffer from their own problems – Europe from a needed but unsettled deeper integration and a mercantile orientation of its biggest economy (Germany), Japan from the deflation which hit there after the implosion of the real estate and stock market bubble in the early 1990s.

To date, China has accumulated the highest foreign exchange reserves in the world.¹³ Figure 4 shows that many other countries have increased their foreign reserves as well, especially developing countries. This development has led to the hypothesis that the world econ-

11 If all countries use expansionary monetary policy to accomplish depreciation no country can depreciate and the world follows an expansionary monetary policy which may trigger growth. However, this is a very special case.

12 The subprime crisis is first of all the result of the deregulation of financial markets in the USA which started already in the 1980s under President Ronald Reagan.

13 At 30th September 2008 China held 1,906 billion \$ foreign reserves, Japan 955 billion \$ and Russia 475 billion \$ (Bloomberg 2008).

omy has implicitly fallen back to a revived Bretton Woods system with the same stabilising effects as the original (Dooley et al. 2003). As in the old Bretton Woods system the US dollar is seen in the centre. According to this hypothesis the periphery consists mainly of Asian countries, with some Latin American countries and Japan stabilising their currencies against the US dollar. The central banks in these countries buy an unlimited amount of US dollars to keep their exchange rates vis-à-vis the US dollar stable. Thus, passively, the USA is pushed into a constellation with high current account deficits. This new system, so the argument, underlines mutual interest and can last for decades as the periphery can follow export-led growth and the United States can achieve high welfare gains due to their overvalued currency.

The hypothesis of a revived Bretton Woods system is not very plausible (Eichengreen 2007). Firstly, the sterilisation policies of central banks can reach their limits. Secondly, the new system is not based on an international treaty. Instead, it is a kind of private cartel. Thirdly, the euro doesn't have a role to play in the revived Bretton Woods system and is in competition with the US dollar. In the case of a collapse of the US dollar only the first central bank that switches from reserves held in US dollars into reserves held in euro will avoid losses. As the number of countries in the revived system is large, the private cartel can break down any time, which can lead to violent exchange rate movements between the euro and the US dollar. Fourthly, for the USA the system is a mixed blessing. Without a doubt it increases the current real consumption in the USA, however, it reduces domestic growth and employment and destroys the entire industrial sector in the USA.

Solutions

The huge surpluses of the Chinese current account are not sustainable and ultimately not in China's best interest. The high proportion of exports in per cent of GDP makes Chinese growth very dependent on world market development, especially on the development in the USA and Europe. In China, consumption as a share of GDP has to be increased and exports as a share of GDP reduced. Over the past years Chinese private consumption in per cent of GDP dropped to around 50 per cent of GDP (China Statistical Yearbook 2008). In international comparison this is extremely low and shows that consumption demand is not sufficiently developed in China. This low consumption is at least caused in part by the unequal income distribution in China and the rudimentary existing social safety-net which also leads to high household savings. This poses a dilemma for Chinese politicians. The external imbalance in the form of high current account surpluses is not sustainable. However, at the same time a reduction in export demand and GDP growth may escalate social tensions in China. Caught in such a quandary, China cannot really be expected to take quick and decisive steps on her own. The economic downturn in the USA after the most recent subprime crisis and the worldwide slowdown will reduce Chinese exports, but it seems that this effect is not strong enough to reduce the Chinese surpluses sufficiently.

The revived Bretton Woods system is crisis-ridden as the centre of the system, the USA, is unable to continue fulfilling the function as the consumer of last resort. Should the USA

fall into a deep and long recession, its current account deficit will most likely become a key political issue. In such a scenario China and other surplus countries will definitely be urged to appreciate and reduce their surpluses in the current account. If the USA follows a policy of reducing their deficit quickly it will probably use administrative measures such as tariffs and quotas.¹⁴ In this case, the USA would suddenly change from being a consumer of last resort to the demand reducer of the world. If countries in the periphery are not helped to overcome current account crises and are forced to reduce domestic growth radically, the world economy will be back in the same constellation as in the 1930s (Kindleberger 1986).

China is merely one part of a larger problem that needs to be solved. It is highly desirable for the world economy to find an effective mechanism to check destabilising current account imbalances firstly by stimulating demand in surplus countries, and secondly by adjusting the exchange rate if there is a fundamental disequilibrium measured in current account imbalances. In Asia adjustment of the RMB exchange rate has to be coordinated with adjustments of a number of other exchange rates in that region (Palley 2005). What is needed is coordinated worldwide demand management, combined with exchange rate adjustments in a situation of fundamental current account disequilibria. Going in this direction means the creation of a real new Bretton Woods system which coordinates macroeconomic policies, central bank interventions in the foreign exchange market, and allows for international capital controls and the revitalisation and reform of the International Monetary Fund.

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¹⁴ Summers (2004) detected as early as 2004 an increasing pressure for protectionist policies in the USA.

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Global imbalances: Strategic prospects for the US and the world

*Dimitri B. Papadimitriou**

Introduction

The prospects for world trade, the motor of growth for many countries for almost a decade, are discouraging especially during a time the global economy is enduring a recession. Since the summer of 2007, trade declined and was exacerbated when trade finance became difficult to obtain for importers, and consumer confidence dropped to unprecedented lows. In December 2008, exports were down in Brazil, China, South Korea and Taiwan by 2, 2.8, 17.4 and 42 percent respectively while in November 2008 exports from the US, Germany, Japan and India were correspondingly lower by 4, 22, 12 and 10 percent respectively – all significant declines (Patel/Trivedi 2009, Norris 2009). Expectations and consensus forecasts for the first quarter of 2009 suggest a decrease in overall trade value around 15 percent in both the advanced and emerging economies and a three percent contraction for the entire year, in real terms. These conditions demonstrate the synchronized slowdown of global demand and the implausibility of any economy to »export its way out of trouble« (Norris 2009). Furthermore, history is full of events illustrating protectionism attempts in many countries intended at improving their trade position with detrimental effects on others. This paper argues that the US and the rest of the world will not be able to achieve balanced

* The Levy Economics Institute of Bard College, New York. This paper draws from the Levy Economics Institute's Strategic Analyses Reports.