April 1, 2011
POLICY REVIEW » NO. 166 » FEATURES

A Smarter Approach to the Yuan

by ***Charles Wolf Jr.***

Avoid the rush to rebalance

THE BEST LAW schools and public policy graduate schools inculcate in their students an ability to make the strongest possible case in favor of a position or policy with which they disagree. The test of whether the lesson has been truly learned is whether those who favor the position would accept its rendition as a fair and effective representation of why they favor it.

With this in mind, I present below the argument for the U.S. stance favoring a substantial rise in the undervalued Chinese yuan. The U.S. position has been repeatedly stated, albeit in abbreviated and nuanced form, by President Obama and Treasury Secretary Geithner. It is also reflected in the large bipartisan majority in the House of Representatives that approved legislation to allow a retaliatory tariff on China's exports to the U.S. unless China revalues its currency. It has been expressed more vociferously and combatively by key leaders in the Senate, and by politically-charged commentators including Paul Krugman.

Once the case for this "pro" position has been presented fairly and fully, I will explain why I think it is fundamentally wrong. I will then go on to suggest measures that would be more appropriate and effective in contributing to a "rebalancing" of China's international accounts as well as those of the U.S. than would a revaluation of the Chinese yuan.

In early January, when President Hu Jintao met in Washington, D.C., with President Obama, the agenda for the meeting deftly acknowledged the presidents' disagreement on the currency issue without discussing, let alone resolving, it.

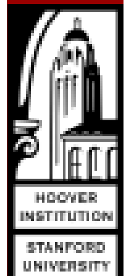
THE CASE FOR REVALUING THE YUAN

THE CHINESE YUAN (also known as the renminbi, or "people's currency") trades in foreign exchange markets at a rate of approximately 6.7 yuan per dollar (equivalent to about fifteen U.S. cents per yuan). Another measure that accords the yuan a considerably higher value is based on the goods and services the yuan can buy within China compared to what these same goods and services would cost in the U.S. This rate is referred to as the yuan's purchasing power parity (PPP). The PPP valuation of the yuan is roughly two or three times higher (between 2.2 and 3.4 yuan per U.S. dollar, or between 30 and 40 U.S. cents per yuan) than the market exchange rate.

Associated with the yuan's value in foreign exchange markets is the fact that the value of China's global exports of goods and services perennially exceeds by large amounts the value of its imports. Indeed, this excess has often been larger than the combined trade surpluses of the two countries that have the world's next-largest trade surpluses, Germany and Japan.

China's annual global trade surplus is currently about $200 billion; the surplus has been considerably larger in prior years. More than half of this global surplus is China's bilateral trade surplus with the U.S. When China's net current earnings from other sources besides trade — including its net receipts from accumulated prior Chinese investments in the U.S., Europe, Asia, and the rest of the world, as well as the remittances it receives from Chinese residents abroad — are added to its trade surplus, the result

policy review



is a Chinese global current account surplus amounting to about $300 billion annually.

The value of a currency that underpins such a large surplus would normally be expected to rise (that is, to "appreciate"). The reason for this expected revaluation is that the dollar demand for that currency (the yuan) by other countries to pay for the imports they receive from China greatly exceeds the supply of yuan resulting from China's requirements to pay for the imports it receives from the U.S. and the rest of the world.

But this normal revaluation process is thwarted because China interferes with the functioning of this standard demand-supply interaction. China does this by withdrawing the surplus dollars from the exchange market, thus neutralizing their effects on the exchange value of the yuan. This is accomplished by compensating exporters for their dollar earnings through direct issuance to them of additional domestic yuan, and then sterilizing the additional yuan by selling government bonds to absorb the expanded supply of yuan currency. This tidy result removes the surplus dollars from foreign exchange markets, while also limiting, if not eliminating, the risk of domestic inflation that might otherwise ensue because of the increased currency generated by exports and circulating in domestic Chinese markets.

China is thus said to be guilty of "manipulating" the yuan's value by preventing its appreciation, and keeping it below its "equilibrium" value. Such manipulation implicitly subsidizes China's exports because the dollar cost of its exports is less than would be the case if the yuan were allowed to appreciate. The lower dollar cost of its exports thus enables China to maintain its trade and its current account surpluses, impeding the ability of other countries to expand their exports and to gain momentum for what in many instances — notably in the U.S. and much of Western Europe — has been a distinctly mild recovery from the Great Recession.

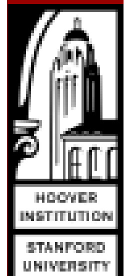
Therefore, it is argued that China can and should appreciate its currency: that is, revalue the yuan upwards. The yuan should appreciate to a rate of, say, five yuan per dollar (twenty U.S. cents per yuan, rather than the current value of fifteen cents), thereby making China's exports more expensive — hence, tending to decrease them. At the same time, this revaluation would make China's imports from the U.S. and the rest of the world less expensive because fewer of the higher-valued yuan would be needed to buy dollar imports, which would tend to increase as a result.

The argument concludes that, in the interest of both bilateral and global "rebalancing," China should be persuaded or pressured to move in this direction. The official U.S. position urges persuasion, the more combative stance of prominent U.S. lawmakers and pundits favors pressure.

THE CASE AGAINST REVALUATION

THE ANSWER REQUIRES looking at the Chinese economy from the inside out, rather than from the outside in, which is the more usual perspective adopted by the revaluation advocates.

What is striking about this inward look is that it highlights the extraordinarily high level of China's domestic savings: between 45 and 50 percent of GDP! Such a high savings rate is without precedent during peacetime in modern economic history and is particularly rare in emerging market economies. It also flies in the face of conventional development theory. The theory presumes that, because developing countries are poor, they will have to consume most of what they produce and to invest the remainder. As a result, so the theory goes, developing countries will have low savings rates, as well as trade deficits rather than surpluses, and therefore will need financial transfers and inward-bound investment from wealthier developed countries to supplement the developing countries' low savings and to pay for their trade deficits.



China stands as a striking counterexample to this standard model because it has an amazingly high savings rate (three or four times that of most developed countries, including the U.S.), accompanied by a large and growing volume of outward-bound foreign investment.

> *China has an amazingly high savings rate — three or four times that of most developed countries, including the U.S.*

China's high savings rate — comprising the combined savings of privately-owned as well as state-owned companies, households, township and village enterprises, cooperatives, and central and local government — is hard to explain. Despite the extensive research underway within as well as outside China, an adequate explanation is still elusive. The reason for its elusiveness probably lies in the fact that there are numerous contributing factors which vary in their prior, current, and future influence on savings behavior by households, individuals, companies, and central and provincial governments.

Demography figures prominently among the contributing factors. China's population is aging rapidly: The proportion of its elderly (over age 65) will nearly double in the next fifteen years. China's dependency ratio (dependents as percentage of those of working age) will rise by nearly 50 percent within this period, and most of this increase will be due to the increasing numbers of elderly, their expectation of higher health care costs in the future, and their hope to ease the burden of these future costs by accumulating current savings.

China's long-standing one-child family policy has been a significant contributor to these trends, reducing the potential sources of support for aging parents and hence increasing the latter's savings propensity. Another demographic imponderable that may affect savings behavior is the marked gender imbalance among China's younger age cohorts — varying between 15 percent and 30 percent more males than females across China's 37 provinces and special administrative regions. Fear by elder family members that a single male offspring might emigrate in the absence of a suitable partner in China may also conduce to precautionary savings.

Along with these demographic trends, increased savings throughout Chinese society and social structure have doubtless been galvanized by delayed development of an adequate social security safety net. What has been taking shape in China is a social security system whose components will include a part that is based on defined contributions by the covered populace, along with a specified floor of defined benefits underwritten by the state. While progress in developing the system is underway, the delay has doubtless stimulated higher savings rates as a source of protection for and by China's rapidly aging population.

But more than demography and social security affect savings in China. The rapid pace of economic growth and the rise in wages and other income that their recipients haven't yet adjusted to may be another part of the explanation. Finally, the prevalence in some circles of generally bearish uncertainties about whether China will be able to sustain in the future its rapid growth of the past may be a further contributor to abnormally high savings as a form of protection against a possible future downturn.

> *China's annual global trade surplus of about $200 billion reflects the excess of its savings above its investment.*

policy review

Whatever the validity and differing weight accorded to these numerous factors, China's huge savings rate exceeds its investment rate by about six to seven percent of GDP. This excess is crucial for understanding China's trade surpluses and current account surpluses. The excess is also central to consideration of what might be done about China's excess savings that would reduce these surpluses, whereas tinkering with its exchange rate would not.

Central to this understanding is an inexorable economic relationship: namely, the excess of any country's domestic savings above its domestic investment must be exactly equal to the excess of its exports of goods and services above its imports of goods and services. In other words, its savings surplus must equal its trade surplus! The relationship is inexorable because it follows from the way that the component elements are defined.

The intuitive common sense behind it can be grasped by thinking of the trade surplus as a bundle of goods and services. That this bundle is saved means it is neither consumed nor invested domestically. The trade (savings) surplus can't be an addition to domestic inventories because additions to inventories constitute investment, whereas the bundle represents the excess of savings above investment. Instead, the surplus bundle, as a part of China's GDP, flows abroad to global markets. The savings surplus and the trade surplus are identical!

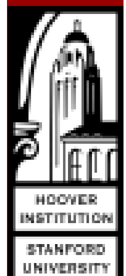
China's annual global trade surplus of about $200 billion reflects the excess of its savings (45 to 50 percent of GDP) above its investment (about 40 percent of GDP). The current account surplus consists of this trade surplus plus its other net current international receipts. As I noted earlier, these current international receipts consist principally of earnings from China's accumulated and continuing investments abroad, including about $40 billion in payments by the U.S. Treasury to service China's holdings of more than $1.6 trillion of U.S. government securities. China's nontrade receipts also include earnings from its other holdings of about $800 billion of additional foreign assets — both corporate assets and sovereign debt assets — as well as remittances by Chinese residents abroad to recipients in China.

To count as add-ons to its current account surpluses, China's current earnings from accumulated assets must be net of the earnings acquired by foreign investments in China. However, because China's corporate and other income taxes are generally lower than corresponding taxes levied in the U.S. and in Europe, foreign investors in China often prefer to meet their tax liabilities in China, to retain their after-tax earnings in the form of yuan holdings, and thus to forgo seeking to convert and remit them as dollars or euros to their homelands. So, the proportion and amounts of China's earnings from its investments that are remitted back to China and hence add to its current account surpluses tend to be larger than the proportion and amounts of earnings by foreign investors in China that these investors remit back to their own countries. It is an interesting facet of China's own nontrade earnings that, by adding to its current account surplus, they indirectly contribute financing for subsequent additional cross-border investments by both state-owned and nonstate enterprises in buying foreign companies or equities in these companies, thereby generating additional earnings in the future.

Revaluation would likely be followed by keen disappointment among its advocates, and sharp recriminations by them.

What I have referred to as an inexorable relationship underlying China's trade surpluses is an iron law — what economists refer to as an "identity," which simply means that the components of GDP — investment, consumption, imports and exports — are so defined that the numbers measuring them must conform to this identity. The identity doesn't say anything about causation — about the many

policy review



influences that affect the size of savings, consumption, investment, and imports and exports — but it does establish inexorably how the parts relate to each other.

China's savings surplus is equal to China's trade surplus. Hence, as long as the surplus of China's domestic savings over its domestic investment persists, tinkering with the pegged exchange rate will have only slight and transitory effects on China's imports and exports. Changing the yuan/dollar peg from fifteen cents per yuan to twenty cents would soon be offset by a compensating fall in China's export prices and a compensating rise in its import prices. This sequence of events would ensue as a result of the inexorable identity between the savings surplus and the trade surplus.

There is another reason why the offsetting price adjustments would be quick and decisive. Much of China's exports consist of value added to imported inputs by processing imported raw materials and intermediate products to produce the final products for export. For example, imports of iron ore, copper, aluminum, cotton, and wool are processed and fabricated, subsequently emerging as exports of consumer products and machinery; and imports of computer chips and hard drives subsequently result in China's exports of electronic and computer products. Often the value added by processing and finishing in China is less than half the corresponding final export from China. Were the yuan to be revalued, the nearly immediate consequence would be to lower the prices of imported inputs sufficiently to compensate, and in many instances to overcompensate, for what might otherwise be reflected in higher prices of the exported final products.

Finally, because of the negligible effects that revaluation would have on China's global surplus as well as on its bilateral surplus with the U.S., if revaluation were nonetheless to occur, it would probably have distinctly adverse political repercussions, quite apart from the absent economic effects. Revaluation would likely be followed by keen disappointment among its advocates, and sharp recriminations by them. Failure to realize the hoped-for turnaround in the bilateral trade balance would be attributed to various barriers impeding American exporters' access to China's domestic markets. Various types of nontrade barriers already and often afford preferential treatment to China's own domestic firms relative to foreign firms in China. But the consequence of a failure of revaluation to achieve the results sought by its advocates would likely be a freshet of hostile charges and counter charges with adverse effects on U.S.-China relations.

A BETTER WAY?

FOR THE TRADE (savings) surplus to diminish and a significant "rebalancing" to occur, China should increase domestic consumption (decrease savings) more directly, more rapidly, and by larger amounts than it has done so far.

This can be done through various measures. For example, taxes can be levied on savings above specified savings thresholds. In the tax filings of urban nonstate and state-owned enterprises, as well as of urban households and individuals, a savings threshold above, say, thirty percent of income after allowing for recorded investment expenditures by businesses and consumption expenditures by households could be subject to heavy taxation. Excessive saving above this threshold would thereby be discouraged. Moreover, the revenues produced by the tax levy could help finance accelerated development of the planned social security safety net referred to earlier.

Additionally, excessive saving can be discouraged and added consumption can be encouraged by active yet prudent expansion of consumer credit.

I make this suggestion in full recognition that, if an American economist proposes the idea, it is likely — and with good reason — to be viewed by China's bankers and policymakers as ironic and hubristic.

policy review

After all, one of the two or three principal causes of the global financial crisis was the egregious and imprudent expansion of consumer credit in the U.S. in the period preceding the Great Recession of 2008 and 2009. Subprime and Alt A mortgages extended in huge volumes to credit-unworthy borrowers by U.S. lending institutions, and then irresponsibly guaranteed with the "full faith and credit of the United States government" by Fannie Mae and Freddie Mac, were the largest and most flagrant part of the consumer credit bubble flooding the American economy in the first decade of the 21st century. So, in advancing the suggestion to rapidly expand consumer credit in China, I feel obliged to accompany it with an ample dose of humility.

Nevertheless, there is a big difference between what was an imprudently excessive volume of consumer credit in the U.S. in the years preceding the Great Recession and the presently constricted availability of consumer credit in China. For example, the ratio of consumer credit to GDP in China is currently seventeen percent, compared with 40 percent in South Korea, 54 percent in Taiwan, and 65 percent in Malaysia. Furthermore, availability of consumer credit cards and debit cards is much more limited in China than in the other emerging market countries in its neighborhood. Thus, there is ample room for China to combine prudence with stimulus in encouraging consumption and curtailing excessive saving. Regulating the expansion of consumer credit, and preventing its abuse, can be readily accomplished in China by extending the purview of China's Banking Regulatory Commission. There would be no need to embark on anything like the Dodd-Frank financial regulatory legislation in the U.S., which, within its 2,000-plus pages, created the Consumer Financial Protection Agency to guard against abuse of the various forms of consumer credit extensions.

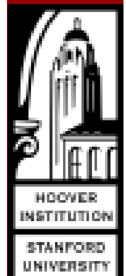
> *There has been a misplaced focus in the soi-disant "currency wars" on the central importance of the yuan's peg to the dollar.*

By targeting the repositories and sources of excessive savings, the measures I've described would affect the basic relationship underlying China's trade (i.e., savings) surplus and its current account surplus, whereas exchange-rate tinkering will not. By reducing the excess of its savings over its investments, these measures will decrease China's global trade surplus, as well as its current account surplus, and thereby contribute to global rebalancing.

In furtherance of some degree of global rebalancing, there has been a misplaced focus in the *soi-disant* "currency wars" on the central importance of the yuan's peg to the dollar. In reality, this mistaken focus will have little if any effect on global imbalances, and such effects as it may have will at most be transitory for the many reasons I've discussed. Instead, the focus of rebalancing efforts and debate should be on the real underlying problem: namely, China's excessive savings.

In the longer-term future, issues connected with valuation of the yuan might be resolved if China were to move to floating its currency, and allowing a freely functioning foreign exchange market to determine the yuan's changing market value. China's previous prime minister, Zhu Rongji, endorsed this prospect several years ago to take place in an indefinitely distant future. Of course, such a scenario is precluded in the nearer term by the limited convertibility of the yuan for capital transactions.

In any event, those who may favor this prospect, including myself, should bear in mind that, if it were to occur in something earlier than a very distant future, the yuan would be as likely to depreciate as to appreciate! At present, China's banks have on their balance sheets more than 70 trillion yuan (about $10 trillion) in liquid deposits held by companies, household, individuals, cooperatives, and other entities — a sum that is twice the size of China's GDP. Were full convertibility to be realized, some of the holders of these yuan assets would doubtless seek diversification of their holdings by converting a



part of them to non-yuan assets, including dollar and euro assets. With the resulting increased demand by yuan-asset holders for nondollar assets, the yuan's value would likely decline.

This scenario seems remote at present but, with changing circumstances, its remote future may become a more plausible present.

WHERE DOES THIS LEAVE US?

THE PRECEDING DISCUSSION appears to place all the burden of global rebalancing on China. In fact, the burden should be shared by the U.S., which should undertake precisely the opposite measures as China. Such reciprocal measures are necessary to reduce the chronic global trade and current account deficits of the U.S. by reducing the shortfall of its domestic savings compared to its aggregate investments. The excess of China's savings above its investment, which most of the preceding discussion has emphasized, is distressingly paralleled by a shortfall of U.S. savings below its own investments.

This shortfall includes the savings and investments of both federal and state governments — mostly large negative savings by these governments in recent years — as well as of U.S. companies, individuals, households, and other entities. Together, these result in a recurring shortfall in U.S. savings of about three to four percent of the U.S. GDP, largely comprised of substantial dissavings (negative savings, thus requiring borrowing) by government, and only modestly positive savings by households and retained corporate earnings in the rest of the economy.

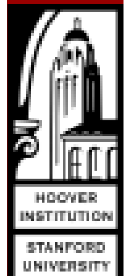
While the burden of global rebalancing should impinge on the U.S. as well as China, there is a critical asymmetry in the respective burdens they can bear. Measures required in China to reduce savings and boost consumption impinge on a Chinese economy that is buoyed by a real rate of GDP growth that remains high — above 9 percent. In sharp contrast, the measures required by the U.S. to limit consumption and raise savings would, in the short run, depress an already low rate of growth and an anemic recovery from the Great Recession accompanied by a near ten percent rate of unemployment.

As a consequence of these immediate problems — problems that are made more serious because of political rather than economic considerations — U.S. monetary and fiscal policymakers have been more concerned with trying to boost the economic recovery by encouraging domestic consumption and investment, rather than addressing the underlying imbalance of a deficiency of aggregate savings compared to relatively excessive consumption and investment — the precise opposite of China's imbalance. The Federal Reserve's announcement at the end of 2010 of its second so-called "quantitative easing" (QE2) illustrates the short-term priorities of monetary policy in the U.S.

> *China should be more able to rein in savings and increase consumption than the U.S. to cut consumption and boost savings.*

QE2 consists of a $600 billion fund intended to monetize public debt, boost the money supply, and flatten the yield curve on government bonds by lowering longer-term yields. The goals of QE2 are to promote investment and job growth through lower interest rates on corporate and other fixed-income securities The goals and the measures to advance them are understandable for the short-term reasons mentioned above. However, these measures run in a direction opposite to what is required for a better degree of long-term rebalancing of the U.S. international accounts. To further the longer-term rebalancing objective, U.S. policy should seek to raise aggregate savings above aggregate investment: more specifically, to tamp down consumption, both private and public consumption,

policy review



reflected in smaller budgets and lower deficits in the budgets of federal and state governments. These are essential goals in the longer term, while the time horizons of political actors tend to be more or less coincident with the shorter terms for which they are elected and in which they usually aspire to be reelected.

As a consequence, in the short run, the relatively heavier lifting to advance global rebalancing can more plausibly be borne by China because its efforts to sustain high GDP growth have been successful, whereas U.S. efforts to resume ample growth have been much less so.

What this means in practical terms is that China should be more able to rein in savings and increase consumption than the U.S. will be able to curtail consumption and increase savings. From China's point of view, reluctance to shoulder this heavier burden arises from the risk it entails of adding to the inflationary pressures recently evident in the Chinese economy. Current inflation in China has more than quadrupled over its rate not long ago: between four and five percent currently versus approximately stable prices in 2009. Efforts to boost consumption by the sorts of measures discussed earlier would likely add to the inflationary risks. Still, by combining a rise in prime interest rates (presently between three and four percent) with a rise in reserve requirements for its banks (recently raised to 19.5 percent), along with appropriate administrative measures, China's policy makers should be able to navigate these moderately roiling waters.

According to a familiar scriptural precept (Luke 12:48): "To whom much is given, from him much will be required; and to whom much has been committed, of him they will ask the more." Similar advice to a wise governor is provided by Confucius (*Analects*, chapter 12, section 2): "Wishing to be established himself, he assists others to be established; wishing to be successful himself, he assists others to be successful.

Charles Wolf, Jr. holds the corporate chair in international economics at the RAND Corporation, and is a professor in the Pardee RAND Graduate School. He is a senior research fellow at the Hoover Institution.

Copyright © 2012 by the Board of Trustees of Leland Stanford Junior University
Phone: 650-723-1754

Source URL: http://www.hoover.org/publications/policy-review/article/73001
Retrieved at 17:45:07 UTC on April 2, 2012

policy review