Future
Social Market Economy

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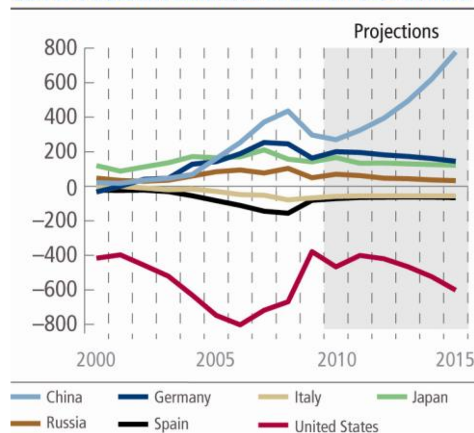
Global imbalances – China-bashing is no solution

The discussion over global current account imbalances has intensified. Notions such as currency wars have come to dominate the debate. Many economists and politicians consider the rapid revaluation of the yuan to be a panacea for global imbalances. However, such a one-dimensional approach runs the risk of triggering a global economic slump. Moreover, an abrupt and massive revaluation of the yuan will do little if anything to address the low U.S. savings rate and the trade surpluses run by other Asian emerging economies. Thus, the elimination of global imbalances demands instead a mix of measures involving action by deficit-running countries as well as countries with a trade surplus.

Focus



Since the late 1990s, large current account imbalances have emerged around the world. Spain, Portugal and Greece have large deficits, too. These deficit-running countries stand in counterpoint to countries with trade surpluses such as Germany, Japan and China. While the current economic crisis and the associated decline in international trade have somewhat reduced current account imbalances, global economic recovery is likely to see them rise once again.

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The belief that global imbalances could be eliminated simply through a rapid revaluation of the Chinese yuan is widespread. In reality however, the attempt to solve global trade imbalances with one-sided adjustment measures that burden the Chinese economy alone, might in fact cause serious problems for the entire world economy. In light of the globe's present overall economic condition, which remains extremely fragile, an abrupt and massive revaluation of the yuan could lead to more damage than benefit. To illustrate how this might happen, we revisit some macroeconomic principles.

1. Permanent current account imbalances are harmful

In the abstract, current account imbalances are not intrinsically worrisome. Neither trade surpluses nor trade deficits are to be condemned, since they are the result of consumer and producer decisions, and thus reflect their preferences. Nevertheless, consistently high current account imbalances can become problematic over the medium and long term.

This is particularly true for deficit-running countries (in which the value of exports is less than that of imports). In the labor market, trade deficits can lead to a rise in unemployment. Foreign debt leads to an accrual of interest and mounting repayment burdens, which means that even once the trade deficit is eliminated, the country must send a portion of its economic output overseas. This becomes a particular problem when trade deficits last for many years. In this circumstance, a continual rise in the level of outstanding foreign debt is seen. If at some point this accumulation of debt causes foreign creditors to lose confidence in a country's creditworthiness, overseas lenders grow increasingly less willing to finance the country's current account deficits through loans. Once this takes place, the deficit-running country must either sell portions of its gold and foreign exchange holdings or must reduce its consumption of goods and services, because without the grant of the loan, the imports can no longer be afforded. This latter course means an abrupt curtailing of consumption, which can lead to societal unrest.

For countries with trade surpluses (in which the value of exports is higher than that of imports), global trade imbalances seem at first glance relatively unproblematic. Trade surpluses help lessen unemployment and the impact of its related social costs (e.g., depressed government revenues, high government welfare payments to the unemployed, growing social inequality, etc.). Trade surpluses allow a country to increase its stock of assets relative to the rest of the world. In times of crisis, these assets can in turn serve as a temporary economic buffer, enabling the population to retain its previous level of consumption. In addition, income flows associated with foreign assets (i.e., interest, profits and dividends) increase the population's disposable income, and thus their long-term consumption opportunities. Particularly for an aging society, in which a decreasing number of workers will coexist with a growing number of pensioners and retirees, the acquisition of foreign assets represents an option by which living standards need not fall despite the aging of the population.

Nevertheless, global imbalances are not risk-free, even for surplus-running countries. The labor market's strong dependence on exports can lead to a precipitous decline in employment levels with the on-

set of a global economic slump. The inflow of gold and foreign exchange holdings increases an economy's monetary base, which can have an inflationary effect. Overseas assets can lose their value if foreign claims become worthless through corporate or even state bankruptcies, for example, or if the foreign currency is sharply devalued. In this case, the surplus-running country would have exchanged its own goods for worthless debt claims, and thus ultimately wasted them.

Finally, the effects of current account imbalances can also have consequences for the broader world economy, affecting even those economies with well-balanced current accounts. In this context, the threat of rising protectionism must be noted. As the deficit-running countries feel rising social pressures associated with trade imbalances, these countries may turn to protectionist measures or currency devaluation as a response. One country's introduction of tariffs and other trade restrictions frequently leads its trading partners to enact corresponding tariff and non-tariff trade barriers. This can lead in turn to a worldwide surge in protectionism or a round of competitive devaluation, in which the international division of labor and its associated welfare effects are substantially undermined.

"As trade deficits mount, so too grows the danger of a worldwide protectionist spiral."

2. Correcting global trade imbalances – revaluation of the yuan is not enough

The Given these negative consequences of persistent current account imbalances, further increases in the global trade surpluses and deficits should at the least be slowed. At the center of any discussion on addressing these imbalances lies in particular the U.S. trade deficit and its relationship to the Chinese trade surplus.

A simple and popular proposal locates the main cause of global imbalances in the undervaluation of yuan. The proposed solution, as mentioned above, is correspondingly simple: It calls for a revaluation of the yuan by abandoning the Chinese currency's fixed exchange rate against the dollar. Because that would make Chinese products more expensive abroad—above all in the United States—this would also reduce Chinese exports. In this way, China's trade surplus and the U.S. trade deficit would both fall. The burden of global readjustment would thus fall on China.

Economic relationships are often distinguished by considerable complexity, however. This is particularly true in the area of international trade and payment balances. As noted above, a trade surplus is caused by more than simply the undervaluation of the home currency. Other conditions enabling an export surplus include cost advantages related to export-good production technologies, which in turn are not undermined by a compensatory rise in factor prices; as well as the presence of adequate restraint in demand for goods by domestic consumers and investors, which translates into a sufficiently high domestic savings rate. In addition, the country must be ready to extend credit to deficit-running countries (in which the value of exports is less than that of imports) in order to finance their current account deficits. Finally the surplus-running country must find a trading partner willing to import more than it exports, to borrow

abroad and to bear the other above-noted negative consequences of running a trade deficit.

An appropriate approach in dealing with current account imbalances would account for their complex origins, rather than seeking to reduce them solely to the undervaluation of Chinese yuan. Thus, the world economy—above all the United States—should not expect too much from a revaluation of the yuan.

In analyzing the U.S. trade deficit, one must look beyond the undervalued yuan to the low savings rate in the United States itself. Relative to U.S. output, Americans consume and invest too much, so that the deficiency in goods in services must be imported from abroad (see box). A yuan revaluation would have little immediate effect on this underlying U.S. imbalance. Indeed, a revaluation of China's currency will do little to reduce the U.S. trade deficit, as long as the United States fails to reconcile its savings and investment levels, and to reduce its consumption. In addition, it is assumed that after a yuan revaluation, the United States would simply begin importing from other fast-developing Asian nations; in this case, the U.S. trade deficit would persist despite China's revaluation.

Furthermore, it is important to remember that China reinvests the income earned through its trade surpluses in global capital markets. China's provision of capital has the effect of lowering interest rates around the world. The United States and Europe have benefited the most from these low interest rates, which have allowed higher rates of investment in these areas than would otherwise have been possible. To the extent that this capital has not been utilized in economically unproductive investments, this in turn has boosted employment, raised national income, and led to stronger economic growth. Considered from this perspective, the victims of China's trade surplus are in fact Chinese consumers, who have lived beneath their means, consuming less than they themselves produce.

Relationships between savings, investment and current account:
The sum of the goods and services produced by an economy in the course of a year (Y) can either be consumed by domestic consumers (C), used for the expansion of productive infrastructure—thus, for investment purposes (I)—or exported overseas (EX). Domestic consumption options are expanded through the import of goods and services from abroad (IM). The following relationships are thus valid: $Y + IM = C + I + EX$ or alternatively $Y - C = I + EX - IM$. The difference between exports and imports is the current account. The portion of output that is not devoted to consumption comprises national savings ($S = Y - C$). From this follows the relationship $S - I = EX - IM$. This in turn means: If national savings exceed domestic investment ($S > I$), a society can export goods overseas and thus achieve a current account surplus ($EX > IM$).

An abrupt and massive yuan revaluation would have the disadvantage of weakening China's export sector, and with it the country's broader process of economic growth. This undermining of growth would also affect the rest of the world—particularly the other emerging Asian economies, the United States and Europe—as China has increasingly become the engine of world economic growth. A decline in economic output and employment in

China would reduce Chinese imports. As Chinese imports represent exports for other economies, a decrease in their amount would reduce export opportunities for the rest of the world. Production and employment levels would fall as a result. Thus, all other exporting countries also benefit from China's export-led growth. Moreover the counterpart of an abrupt yuan revaluation—that is, the massive devaluation of the U.S. dollar—has to be kept in mind. An abrupt devaluation would destroy trust in the dollar. This would prompt an increase in the U.S. interest rate—which itself would entail a slump in investment and employment—and plunging stock prices. These effects would induce an economic downturn in the United States, which could ripple outward into global economic crisis. In addition, a strong depreciation of the dollar would cause substantial loss in asset value not only for China, but for everybody who holds U.S. dollars and other U.S. assets. These losses could cause a global economic slump similar to the consequences of the bursting of the U.S. real-estate bubble.

Finally, it is useful to remember that the mirror image of the U.S. trade deficit, from the perspective of balance-of-payments mechanics, can be seen in the net inflow of capital to the United States. The high level of capital inflow to the American market results from the fact that there are more attractive investment opportunities in the United States than is the case in many other countries. From this perspective too, a yuan revaluation would change little. Revaluation would make production in China more expensive, and thus lower return on capital in China. Conversely, abrupt depreciation of the U.S. dollar would boost the U.S. economy's international competitiveness, thus also improving profits and capital yields. This would make investment in the United States even more attractive, which in turn could boost net capital flows into the United States and exacerbate the U.S. current account deficit, if U.S. exports did not grow by a corresponding amount.

"Revaluation of the yuan would contribute little to the reduction of global imbalances."

3. Reducing global trade imbalances needs a mix of measures

Due to the economic risks outlined above, an abrupt and massive revaluation of the yuan does not represent a reasonable option in the attempt to eliminate global imbalances. Less dangerous would be a modest yuan revaluation. However, a modest revaluation of the Chinese currency would contribute little to the elimination of global trade imbalances. Thus, additional economic policy measures are required. First among these to be considered should be a strengthening of China's domestic demand, and a corresponding reduction in the Chinese savings rate. This would ensure that a larger portion of Chinese output remained in the domestic market, rather than being exported overseas. An increase in China's real wages, a necessary condition for growth in domestic demand, is already under way. Rising wages mean that business profits fall, which leads to a decrease in firms' savings, and so to a further decline in Chin's overall savings rate. Additional structural reforms in China would also be helpful in reaching this goal—for example, the elimination of factor market distortions such as interest subsidies and artificially low energy prices, which have in turn artificially de-

pressed capital costs and energy costs—and a strengthening of the social welfare system. With respect to the yuan's current dollar peg, an alternative could be pegging the yuan instead to a basket of currencies, a substantial share of which would be represented by the euro and the yen. Chinese exports could thus be redirected toward Europe and Japan. This would reduce the American trade deficit without bringing an abrupt end to China's growth process.

"Every country must tend to its own problems"

When viewing trade surpluses in other emerging Asian economies, it is useful to remember the need for further construction of Asian infrastructure, which would itself create the conditions for sustainable growth. This type of infrastructure investment would employ goods and services in these countries, and thus reduce their exports, leading in turn to a decline in trade surpluses.

Reducing the American current account deficit first of all requires a decline in consumption and an increase in national savings. In addition, it is necessary to take into account the fact that the U.S. dollar currently serves as an international reserve currency. For emerging Asian economies, this has resulted in the need to build up dollar reserves in order to support their own currency in the event of exchange rate volatility. As a result, these countries have sought to achieve trade surpluses. For the United States, the fact that its domestic currency is at the same time an international reserve currency results in a current account deficit, because this deficit is necessary if it is to supply the rest of the world with the necessary reserves. As long as the U.S. dollar retains its status as an international currency, trade deficits are unavoidable for the United States. Thus, it would be desirable to use instead a supranational reserve currency, such as today's Special Drawing Rights (SDRs), or to create a new basket of currencies to serve this purpose.

Finally, it must be remembered that some current account imbalances will essentially resolve themselves. Japan's trade surplus will decline as a result of its aging society, as the population will increasingly demand goods and services for its own use (especially in the form of services for the elderly and health care). The country's export surplus will correspondingly decline. In emerging Asian economies, strong economic growth will lead to a growth in real wages and a rise in living standards. This will redirect goods and services to these economies' domestic markets, thus lowering the countries' trade surpluses.

Conclusion

In sum, because of the negative consequences of persistent and climbing current account imbalances, a controlled reduction in these imbalances is imperative. To this end, it helps little to point solely at China, or to treat revaluation of the yuan as a global panacea for imbalances. Rather, it is necessary to view Asian economies as a totality, and to recognize the homegrown problems in deficit-running countries. In the United States, there is a need to raise the savings rate and reduce consumption levels. Japan and the European surplus-running countries should strengthen their domestic demand, allowing them to reduce reliance on export-led growth without creating unemployment or other social disruptions. Deficit-running countries in Europe should improve their international competitiveness through methods such as innovation or a reduction in production costs. With a view to the global monetary order, pegging the yuan—and other Asian currencies—to a currency basket containing substantial contributions by the euro and the yen would help to distribute the burden of adjustment more equally. Furthermore, the conversion to a supranational reserve currency would help to reduce global imbalances.

Given the world economy's complex level of interconnectedness, it is in the American and European interest to support a lasting growth process in Asia, as higher incomes in Asia will lead to a growth in the region's imports, and thus help create jobs in the United States and Europe. Any strategy that places the burdens of adjustment wholly with the Chinese or other Asian economies runs the risk of triggering a global economic downturn. This outcome would benefit no one.

References

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The “Future Social Market Economy Policy Brief” is a publication of the Bertelsmann Stiftung project concerned with the future of social market economies. In this project, designed to span several years, the Bertelsmann Stiftung seeks to revitalize the social market economy model by updating its fundamental ideas and principles, thus securing its fitness for the future and suitability for use at the German, European and global levels.

The “Future Social Market Economy Policy Brief” offers critical comment on current topics and events related to the social market economy idea in Germany, Europe and the rest of the world. Six to eight issues will be published a year, at irregular intervals. Individual briefs may be written in German or English. Authors bear sole responsibility for the content of each policy brief.

Responsible

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