China (and US) Currency Policy & Global Imbalance

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The Plan

- The Obvious Facts
- The U.S. Perspective
- China’s Perspective
- The View from the Rest of the World
- A Way Forward
- Closing Thought on the pre-G20 Vows
Obvious Facts (1):
China has a large current account surplus, US has a large current account deficit. This is true when expressed in $US billions…

Source: Haver Analytics
Obvious Facts (1):
...or when expressed as a percent of GDP.
Obvious Facts (2):
China manages the value of its currency vis-à-vis the USD.

Evidence: Enormous reserve accumulations the past decade, and the exchange rate moves only during distinct periods.
Obvious Facts (3):
The U.S. economic situation is less than encouraging.

United States: The Un- and Under Employed Rate

Source: Bureau of Labor Statistics /Haver Analytics
Obvious Facts (4):
With fiscal paralysis, it falls to the Fed to try to spur economic growth. And they’ve indicated they are willing to do so.
Obvious Facts (5):
The surge in capital inflows that many countries experienced in the 2004-07 period gave way to an unprecedented number of sudden stops. A new wave of inflows appears to be gathering power.

The U.S. Perspective

• China is managing its currency to keep it from appreciating.

• It does so precisely to enable its export sector to flourish at the expense of other countries.

• In doing so it fosters global imbalances. It helped keep U.S. borrowing rates low, thereby stoking the bubble that burst into the global financial crisis.
The Chinese Perspective

• The US is managing its currency to keep it from appreciating. Not as overtly as we are, but the U.S. mix of paralyzed fiscal policy and loose monetary policy will naturally depreciate the dollar.

• It does so precisely to enable economic growth, and some of this would come at the expense of other countries.

• In doing so it fosters global imbalances and forces a massive flow of funds to the rest of the world, potentially stoking the next round of bubbles that will eventually burst.
The View from the Rest of the World

• China and the US are both actively trying to depreciate their currencies.

• In doing so they are prompting a massive wave of funds to search the world for higher returns.

• While we like the attention, too much of a good thing has led to problems in the past.
  - Some bad decisions will be made.
  - And might a prolonged surge in capital inflows morph into an abrupt sudden stop?

• What are we to do?
  - Capital controls? Massive reserve accumulation? Or let our exchange rates appreciate sharply?
A Way Forward

• The US and China should agree that
  - China is manipulating its currency overtly through its exchange rate policy, and
  - the US is manipulating its currency covertly through its combination of fiscal, monetary, and tax policies.

• Address the underlying forces at work
  - Both should agree to address some of the underlying forces that are at work. These include…
A Way Forward: Address the Underlying Forces

- China is too big to continue relying on selling to the rest of the world as its engine of growth.
  - It should allow the financial sector to develop (i.e., end financial repression), enabling better access to finance.
  - It should address the lack of a social safety net and other social insurance.
  - Households would then naturally consume more and save less, and the CA surplus would decrease.
A Way Forward: Address the Underlying Forces

- US should
  - Allow a normalization of monetary policy
    – Could be done by ending its fiscal paralysis and implementing a fiscal stimulus package coupled with a credible medium-term fiscal rule to deal with dangerous medium-term debt dynamics.
  - Rework tax and other policies to incentivize savings rather than consumption.
A Way Forward
Address the Underlying Forces

• What are the alternatives?
  - To inflate their economies, US, Europe and Japan will have non-coordinated super-expansionary monetary policies. Could work, but will lead to currency volatility and possibly also to trade protectionism.
  - Countries doing better will either import these monetary policies (which are inappropriate for them) or face massive inflows and currency appreciation.

• Or U.S. and China could address the underlying issues.
Relative to the pre-G20 vows

• Not too different in spirit, but a fixation on numerical limits for the current account balance isn’t likely to be helpful.
  - Numeric limits can be gamed or ignored (think eurozone debt/deficit limits), statistics can be manipulated (country names withheld).
• Should focus instead on some root causes of the imbalances.
  • Financial repression, social safety net, and currency management in China.
  • Policies that favor consumption over saving in the US. If you want to address large persistent CA deficits (see Freund and Warnock 2007 for some analysis), focus on the root causes.