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HD **We Are All in It Together**

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LP In 2005, the People's Bank of China, counterpart of our Federal Reserve, accumulated $200 billion of additional reserves and is well on its way to holding $1 trillion of reserves, passing Japan as the largest holder of reserves in the world. The accumulation in 2005 was the policy action that caused the value of the yuan to remain stable relative to the dollar.

Casual conversation and commentary lead most Americans to think that this accumulation of reserves corresponds to a large trade surplus in China, achieved by holding the value of their currency down. In fact, the Chinese trade surplus is not that large. It is well under 5% of GDP, smaller in percentage terms than the U.S. trade deficit.

TD The accumulation of reserves in China is not primarily a trade-surplus issue. In 2005, China's trade surplus was $50 billion. Net inbound foreign direct investment was another $50 billion. And then, notwithstanding capital controls, there was an additional, largely unwanted net capital inflow of $100 billion. One can think of this as speculative investment, not caught by the capital control system.

The combination of the trade surplus and another $150 billion surplus on the private capital account (adding up to $200 billion) would have put strong upward pressure on the value of the currency, risking a sudden and steep loss of competitiveness. To prevent this China bought foreign and largely dollar-denominated assets. It is clear from the numbers just cited that three-fourths of the reserve accumulation was designed to undo the large net positive inflow on the capital account, and not just the trade surplus.

China's trade surplus with the U.S. is running in excess of $200 billion, much larger than its overall trade surplus. Why? It runs large deficits in commodities and energy, and in capital goods imported from other countries particularly in East Asia. It would not take much (another round of increases in energy and commodities) to eliminate the trade surplus -- though not the net inflow on the private capital account.

Exports have been, and are, an important driver of growth in the Chinese economy. The concern is that the large surplus on the private capital account will push the exchange rate up and make the export sector less competitive, resulting in a slowing of growth. The strategy is to gradually let the yuan rise in value, monitoring the effect on exports and growth. In effect, China has modest inflation and a reasonable balance between demand and capacity, but is out of external balance. The policy is to maintain internal balance while simultaneously moving toward external balance without losing growth. This involves letting the exchange rate rise but at a measured pace, reducing the excessively high rate of domestic saving and stimulating domestic consumption to take up the slack created by any loss of momentum in exports. In short, the mix of exports and the (now large) domestic economy as drivers of growth will shift steadily over time.

Chinese policy makers understand that holding the exchange rate down and preventing this shifting mix runs the risk of locking the economy into a labor intensive export mode for too long. Letting the currency rise will put the right kind of pressure on the economy to evolve as incomes rise. As is usual in healthy policy environments, there is a lively internal debate about what the right speed is.

It is worth noting that many other countries are accumulating reserves (not at China's level, but still significant), which means they are to some extent holding the values of their currencies down. Unlike China, most of them do not have the large capital inflows with which to contend.

There are two motives for this reserve accumulation, which has become pronounced since the late '90s. One is to put the countries in a position to exercise some control over the exchange rate, and

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hence their competitive positions in global markets, exports and growth. The other is a kind of self-insurance, admittedly expensive, against having to borrow in periods of volatility or crisis, and weakness. This appears to be one of the lessons, learned bitterly, in the currency crises of the late '90s.

The U.S. position on China is politically driven and is partly right and partly incoherent. The part that is right, and well understood in China, is that holding the yuan down removes pressure for the economy to evolve and keep up with development. Another point on which there is at least some agreement among professionals in finance, economics and policy inside and outside of China, is that there is much to be done to increase the capacity, transparency and efficiency of the financial-services sectors in China, a necessary preliminary to safely opening up the capital account by removing capital controls.

One of the puzzling features of **China's 28 years** of high growth has to do with how it was accomplished without more capacity and allocative efficiency in the financial sector. Its performance runs counter to conventional doctrine in economics and to the advice that is often given to developing countries about reform priorities. As China's capital markets mature, and capital controls are reduced, the authorities will allow domestic savings to be channeled into foreign investment, a step which could produce a large increment in private capital outflows and would considerably reduce the accumulation of reserves in the People's Bank of China.

The part of our foreign-policy stance that is incoherent is the implicit (sometimes explicit) notion or belief that our overall trade deficit or our bilateral trade deficit with China is closely connected to China's policy of neutralizing the impact of the trade surplus and capital inflows. The U.S. trade deficit (goods and services) in 2005 was $716 billion. There was actually a surplus on the services side of $66 billion, larger than the Chinese trade surplus. The trade deficit represents about 5.5% of U.S. GDP. The bilateral trade deficit with China is about 28% of the overall trade deficit in the U.S.

Our trade deficit is the mirror image of the difference between domestic saving and domestic investment in the United States. As long as that difference persists, we will run a large deficit on current account. And that will be perceived as exporting jobs, at least in the sectors that are impacted and in the political arena. If China and Japan stopped accumulating reserves and let their currencies' values rise more quickly, it is possible that the U.S. savings rate would shoot up closer to investment, but not likely. More likely is that the U.S. trade deficit would simply readjust as a portfolio matter among other exporting countries in the developing world. No one knows with certainty.

Japan and China, for similar but somewhat different reasons, have a problem with high savings. The excess of savings relative to investment goes abroad. The U.S. has the opposite condition. We finance a deficit of savings relative to investment with foreign investment. Two of those large foreign investors are the central banks in Japan and China.

They could change their behavior in the near future, developing a sudden lack of willingness to buy additional dollar-denominated assets, but such a sudden change is very unlikely. Not only do they not want a sudden shift in the values of their currencies, but a sudden shift away from accumulating reserves would cause the dollar to fall further, raise the value of their own currencies and reduce their export growth by an indeterminate amount. It would also force savings up or investment down -- or both -- in the U.S., producing with near certainty a recession here that would be exported world-wide in short order. In this sense we are all in it together.

The graceful way out of this is gradual: an increase in U.S. savings relative to investment, a reduction in savings relative to investment in China and Japan, a probable further lowering of the market-determined value of the dollar in the short and medium term. As part of the process, it would be useful if we stopped pretending or alleging that China's exchange-rate policies are the root cause of our trade deficit.

If our savings rate is stubbornly stuck below our investment rate, and if China does allow its currency to revalue over time, then we will simply run a deficit with another collection of countries, and from a domestic point of view, nothing much will have changed. Except that we won't have this subject to discuss with China anymore.

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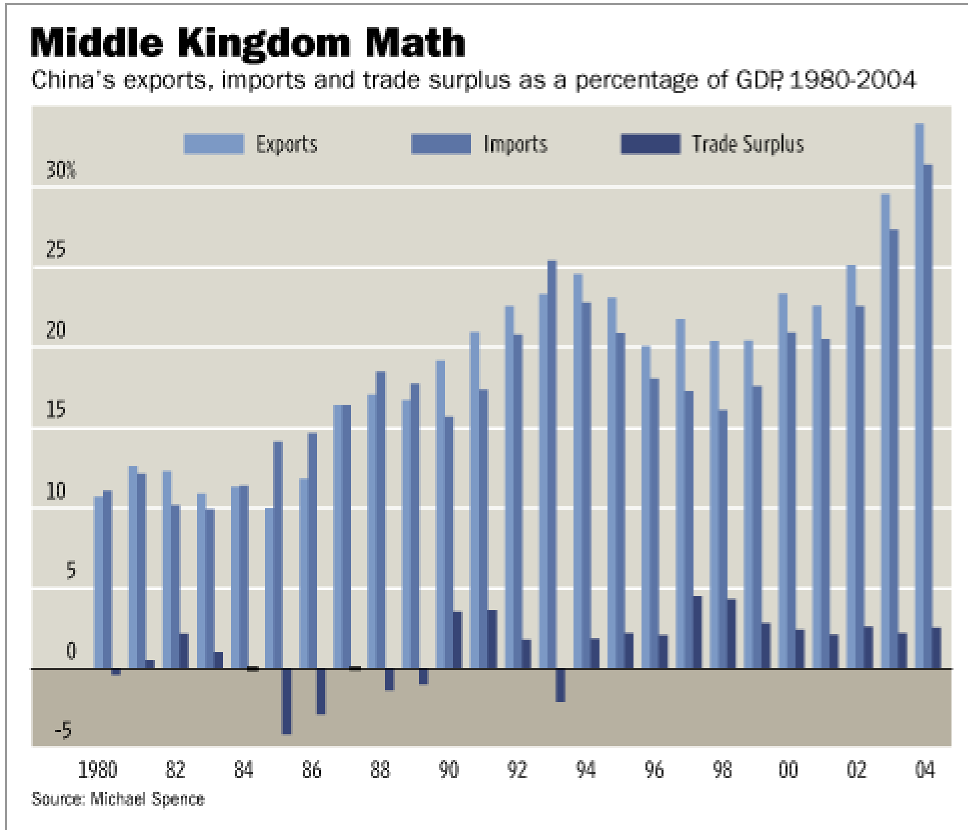

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