Chinese Exchange rate, the US current account deficit, and the Global imbalance

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The growth pace of Chinese current account surplus in the past few decades has been remarkable. It jumped from about 2.5% of Chinese GDP in 2002 to the peak in 2007 when the current account surplus accounted for more than 10% of GDP (Figure 1). The 2008 - 2009 global financial crises hammered down the current account surplus dramatically, but it still hangs at about 4% in 2011.

In contrast, the United States ran in the opposite direction – consistent and rapidly increasing current account deficits up until 2006 when the deficit reached about 6% of the total GDP of the US. The 2008 – 2009 financial crises wrecked the US economy and shocked the US consumers, resulting in a sharp contraction in the current account deficit. The US current account deficit subsequently bottomed at 2.7% of GDP in 2009. But such a deficit contraction was short-lived. It started to expand again in 2010 and 2011. One can expect that, with the gradual recovery of the US economy from "the great recession", the rising pace of current account deficit would be likely to pick up again.

These concurrently opposite runs on current account balance in China and the United States and the flash reversal of current account balance in both countries, albeit quick and incomplete, naturally lead people to question whether these two events have a causal relation. In other words, are large deficits in the US caused by the large surplus in China?

This is certainly not the first time that people have raised similar questions. Since the early 2000's, there has been vigorous debate on the association of the large and rapidly growing Chinese current account surplus, the global payment imbalance, and the US swelling current account deficit. One of the drivers of the US current account deficit is the persistently large trade deficit against China. Many observers argue that, in addition to the rapid improvement of productivity in China, China arbitrarily undervalued its currency, RMB, to gain an unfair comparative advantage for its exports. This argument has been quite popular among the policy circle. Enormous political pressures have been

sent from the U.S. lawmakers and government to push the Chinese government to revaluate the RMB. During the current time period when policymakers seek to establish the foundation for a sustained recovery from the world's most serious financial crisis since "the great depression" in 1930, the pressure over the Chinese currency issue is mounting. The most recent one is a bill passed in the U.S. Senate in Oct. 2011. The lawmakers argue that China's policy of holding down the value of the RMB benefits China's exporters by acting as a trade subsidy. The U.S. therefore will impose extra tariff on Chinese exports to the US. Although it has been relatively quiet in the first quarter of 2012, one believes that, when the election of Nov. 2012 is approaching and the political debates are intensified, the Chinese currency manipulation issue will be emerging again.

Before one can validate the merit of the aforementioned argument that China uses its undervalued currency to subsidize its exports, causing the US trade deficit, it is useful to obtain a clear answer to the following questions: 1) Is RMB really undervalued? If it is, by how much it is undervalued? 2) Can the revaluated RMB exchange rate reduce the US current account deficit and rebalance the global economy?

There is a plethora of economic studies examining whether the RMB is undervalued. However, the findings are far from conclusive, particularly regarding to the extent to which the RMB value has been undervalued. Various studies yield a wide range of estimation for the RMB undervaluation from almost 0% to as far as 50%. Some find that the RMB is undervalued by from 20% to 50% (e.g. Coudert and Couharde, 2007; Goldstein, 2004; Frankel, 2004); others find that that the undervaluation of RMB is small, say, less than 5% (e.g. Lee et al. 2005; Wang, 2004). Cheung, Chinn, and Fujii (2007) find little statistical evidence that the RMB is undervalued. Professors Cheung, Chinn, and Fujii produced a series of studies to track down the critical reasons why there is such a wide range of estimation for the RMB undervaluation. They revealed three main sources - the choice of modeling approaches, the impact of data uncertainty, and the selection of econometric methods. Any modification in one of the above three could yield strikingly different results. For instance, many studies use the national price level data from International Comparison Program (ICP). A data revision in ICP would induce a wild change to the results of many studies on RMB undervaluation. As Cheung and Fujii

(2011) point out that the new undervaluation estimate for 2004 using the revised ICP data turns out to be around 18%, which is only about one-third of the "old" estimate of 53%.

It seems to be challenging to precisely estimate the degree of RMB undervaluation. Now let us turn to the second question – even if we assume the RMB is undervalued, can a revaluated RMB alter the U.S. deficit and rebalance the global economy? There are again vigorous debates in both the academic and policy circle. One of the main schools of thought argues that the RMB revaluation will have a limited effect on the U.S. deficit. Since China's weight in the Federal Reserve's trade weighted index for the dollar is only about 15 percent, a 20 percent appreciation of RMB against the U.S. dollar would only translate into 3 percent depreciation in the trade weighted U.S. dollar. This hardly contributes to the overall current account deficit. Indeed, the RMB has been appreciated more than 20% since July 2005. The U.S. imports from China, however, have been growing at a pace even faster than it was before 2005. Moreover, even the prices of Chinese exports are more expensive after the revaluation of RMB and subsequently the U.S. reduce their demands for imports from China, the U.S consumers will probably turn to the imports from other countries, e.g. other East-Asian countries, for substitution, making the U.S. deficit remain at the same level as it used to be. Thus, some suggest that the U.S. should constrain the spending spree, and raise its own national saving rate, if it wants to significantly improve future U.S. current account deficits (Roach, 2007).

The United States and China are the two biggest economies in the world. The large and persistent current account imbalances in these two countries reflect, to some extent, the imbalances of global payment, which were blamed for playing a predominant role in causing the current financial crisis. To correct the global imbalances, it is not merely a matter of the U.S. and China (Chinn, Eichengreen and Ito, 2010). In fact, besides China, Gemany, oil-exporting countries, and other emerging Asian countries account for a significant share of global current account surplus as well. On the deficit side, even though the U.S. current account deficits are still dominant, the southern Europe peripheries are also in the trouble of deep deficits. Apparently, the RMB revaluation is not the only solution to the rebalancing of the world economies, let alone that it may only have limited effect on the U.S. current account deficit.

Although a revaluated RMB may not resolve America's deficit issues, a more flexible, even free floating, RMB exchange system and a fully convertible RMB capital account serve for China's own interests and, in some sense, may help correct the global payment imbalances. China abandoned its fixed exchange rate in July 2005 and currently has adopted a "managed floating system", where the exchange rate is determined more flexibly "with reference to a basket of currencies". But the daily fluctuation of exchange rate is limited in a narrow band of 0.5% in either direction[1] and the component currencies and their weights are still kept as a secret. According to a number of authors (e.g. Ogawa and Sakane, 2006; Frankel and Wei, 2007), China has a *de facto* peg to the U.S. dollar since July 2005.

Given the size of the Chinese economy and the growth perspective, it is widely seen that the RMB will eventually free float and be fully convertible, allowing China to operate a more independent monetary policy. The key is the timing of letting RMB freely float. Many think that it is for China's good to do it now when both the economy and the RMB are strong, rather than waiting until the economy is cooling and the currency is under attack (the devastating experience of many East-Asian countries in 1997 financial crisis).

However, floating the RMB is much more complicated than a simple timing issue. The RMB exchange rate system intertwines with all aspects of Chinese economy. A rush to liberalize the RMB exchange system could cause ill effects on the Chinese economy, particularly for the weak domestic financial system which may find itself hard to survive under the fierce competition from the incoming foreign capitals. Thus, in the process of liberalizing the RMB exchange system, China should put each step in a proper order – they are not necessary to be implemented simultaneously, but the cart should not be in front of the horse. As Prasad et al. (2005) point out that "a flexible RMB exchange rate system may go first, but a more stable and robust financial system should be regarded as a prerequisite for undertaking a substantial liberalization of the capital account".

[1] As an effort to enhance the flexibility of RMB exchange rate, China expanded the RMB daily trading band against US dollar to 1.0% in either direction in April 16, 2012.

In addition to freeing the RMB exchange rate and liberalizing the capital account convertibility, it is necessary for China to adjust its economic structure and rebalance its economy first. For instance, China may shift away from an investment-intensive and export-led growth model to a more domestically demand-driven economic structure, reinforce social safety network to reduce household precautionary savings, deregulate the service sector to encourage more private investments in non-tradable sectors, and promote a balanced and sustainable economic growth across regions and industrial sectors.

To sum up, the emergence of China in the 21st century as the second biggest economic power in the world and its great integration into the global economy make China increasingly influence the global markets. The large current account surplus that China built up in the last few decades is not necessarily the only reason that caused the persistent current account deficit in the United States and the global imbalance. However, a more aligned and flexible RMB exchange rate may not only benefit the Chinese economy itself, but also to some extent may help the U.S. alleviate its huge current account deficit and alter the trend of global imbalance. In view of the complication, the rebalancing process in China, in the United State, and of the global imbalance is likely to be an extended one. It needs multilateral efforts and coordination of major industrial and emerging countries and other international organizations.

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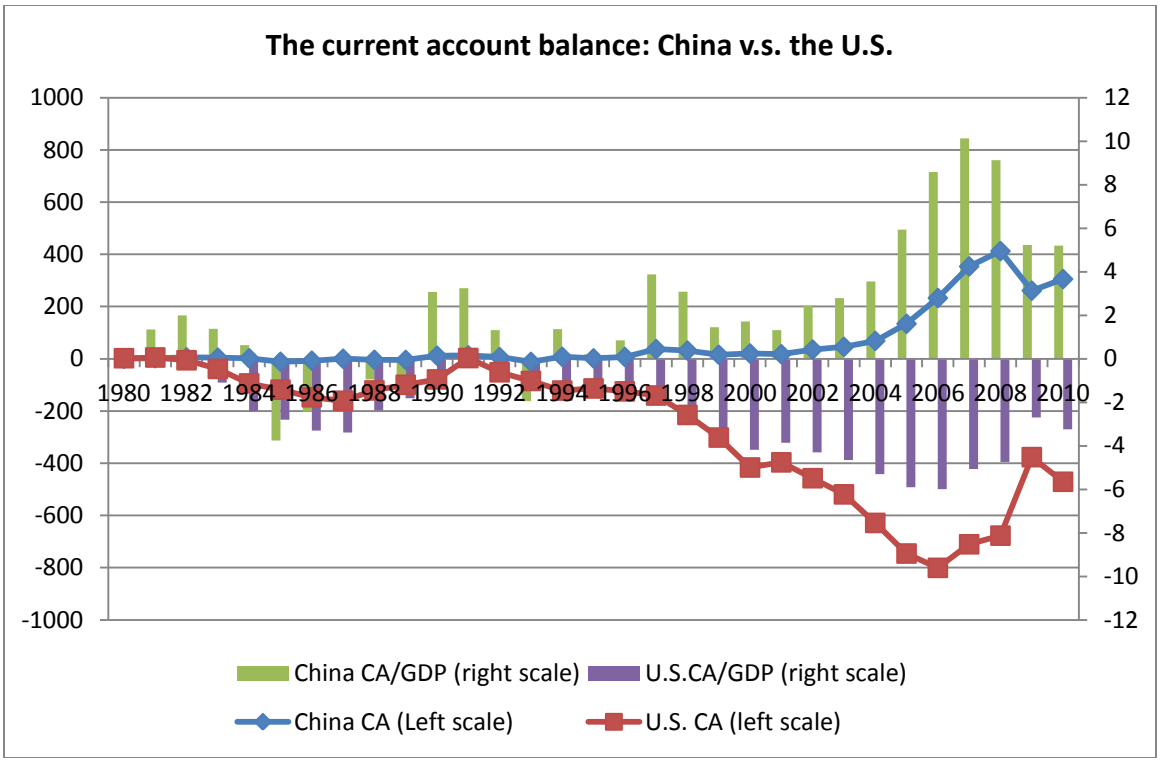

Figure 1: The current account balance of China and the United States, in Billions US dollar (left scale) and in percent (right scale). Data source: CEIC.

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