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Phone: 202-861-0791 • Fax: 202-861-0790
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Same Old Same Old

The danger of the United States and China going back to their old ways.

BY KENNETH ROGOFF

As the global economy stabilizes, there is a growing danger that the United States and China will slip back into their pre-crisis economic patterns, placing themselves and the rest of the world at risk. Despite Chinese official rhetoric about the need for a new global currency to replace the dollar, and U.S. lawmakers' flirtation with "Buy American" clauses (which scares everyone, not just the Chinese), no one will want to rock a boat that has almost capsized. So China continues to run a giant trade surplus, and the United States continues to spend and borrow.

Short-run stability certainly seems attractive right now. But if the U.S.-China trade and debt relationship merely picks up where it left off, what will prevent recurrence of the same unsustainable dynamic that we just witnessed? After all, huge U.S. foreign borrowing was clearly a key factor in creating the recent financial mess, while China's excessive reliance on export-driven growth has made it extraordinarily vulnerable to a sudden drop in global demand.

A giant fiscal stimulus in both countries has helped prevent further damage temporarily, but where is the needed change? Wouldn't it be better to accept more adjustment now in the form of slower post-crisis growth than to set ourselves up for an even bigger crash?

True, both the U.S. administration and China's leadership have made some sensible proposals for change. But is their heart in it? U.S. Treasury Secretary Timothy Geithner has floated a far-reaching overhaul of the financial system, and China's leaders are starting to take steps towards improving the country's social safety net.

Both of these measures should help a lot in bringing the U.S. and Chinese trade balances toward more sustainable levels. Greater financial regulation in the United States means consumers will not be able to borrow so easily to rack up huge mortgage and credit card debt. Chinese consumers, on the hand, might actually start spending more of their income if they can worry a bit less about saving for health care, their children's education, and their old-age retirement.

Nevertheless, there is cause for concern. As the world seems to emerge from its horrific financial crisis, it is human nature for complacency to set in, and the domestic politics of the U.S.-China trade and financial relationship are deeply rooted. One shudders to think what lessons the U.S. financial sector will draw if, after the multi-trillion dollar bailout, there are only superficial, toothless reforms. And will China's coastal export interests again prevail in exchange rate policy decisions, at the expense of poor inland consumers?

Another reason to worry is that the global recovery is still fragile. U.S. and Chinese leaders have fought the crisis with not only massive fiscal stimulus, but also deep intervention into credit markets. Such extraordinary fiscal largesse, all at taxpayers' expense, cannot continue indefinitely.

World Bank President Robert Zoellick has rightly warned that all this massive temporary fiscal stimulus is a "sugar high" that will ultimately pass without deeper reforms. As I have argued before, the endgame to the financial bailouts and fiscal expansion will almost certainly mean higher interest rates, higher taxes, and, quite possibly, inflation.

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For better or for worse, it may not be possible to turn back the clock. The U.S. consumer, whose gluttony helped fuel growth throughout the world for more than a decade, seems finally set to go on a diet. In addition to tighter credit, falling home prices and high unemployment will continue to put a crimp on U.S. consumer spending.

Frankly, higher U.S. personal saving rates would not be a bad thing. It would almost certainly help reduce the risk of an early repeat of the financial crisis. The obvious candidates to replace them are Chinese and other Asian consumers, whose combined economies are more than equal to that of the United States. But are Asian governments prepared to abandon their mercantilist paradigm? Outside Japan, Asia policymakers certainly don't seem amenable to exchange-rate appreciation.

Since the beginning of this decade, at least a few economists (including me) have warned that the global trade and current-account imbalances needed to be reined in to reduce the chance of a severe financial crisis. The United States and China are not solely responsible for these imbalances, but their relationship is certainly at the center of it.

Prior to the crisis, there was plenty of talk, including high-level meetings brokered by the International Monetary Fund, but only minimal action. Now, the risks have spilled out to the entire world. Let's hope that this time there is more than talk. If U.S. and Chinese policymakers instead surrender to the temptation of slipping back to the pre-crisis imbalances, the roots of the next crisis will grow like bamboo. And that would not be good news for the United States and China, or anyone else. ◆

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the International Monetary Fund.